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Two Stories About Shareholders

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Abstract

Corporate law contains two contradictory stories about the role of shareholders. In one, the shareholders are a useful countervailing force against the self-interested behaviour of corporate agents. In the other, shareholders lack the motivation, information, and proper incentives to contribute to the good governance of business corporations. Both stories are true on occasion, but is one generally more true than the other? Currently, developments in corporate and securities law are predicated on the idea that shareholders are, generally, a positive force in corporate governance. This seems to be a corollary of agency cost theory, the dominant paradigm for understanding the relationships between corporate actors. This article reviews the body of empirical research on the outcomes of the various forms of shareholder activism. Proposals, proxy campaigns, and takeovers represent the most impactful and costly forms of shareholder engagement with corporations. As it happens, the empirical evidence does tend to strongly support one of the two stories about the role of shareholders, but it is not the one currently dominating law reform efforts. If the character of shareholder interventions generally supports the story that shareholders lack the proper incentives and information to contribute to positive business outcomes, then much about the current regulatory scene needs to be re-evaluated.

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BRYCE C. TINGLE*

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This article reviews the body of empirical research on the outcomes of the various forms of shareholder activism. Proposals, proxy campaigns, and takeovers represent the most impactful and costly forms of shareholder engagement with corporations. As it happens, the empirical evidence does tend to strongly support one of the two stories about the role of shareholders, but it is not the one currently dominating law reform efforts. If the character of shareholder interventions generally supports the story that shareholders lack the proper incentives and information to contribute to positive business outcomes, then much about the current regulatory scene needs to be re-evaluated.

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I.	THE STORIES	59
A.	The Good Shareholder Story	60
B.	The Bad Shareholder Story	63
C.	The Two Stories Considered	70
II.	THE IMPACT OF THE TWO STORIES	71
III.	EMPIRICAL EVIDENCE ABOUT THE STORIES	76
A.	Shareholder Proposals	79
1.	What Do We Know About Shareholder Proposals?	79
2.	What Do We Know About the Outcomes of Shareholder Proposals?	82
3.	What Conclusions Can We Draw from Shareholder Proposals?	84
B.	Activist Shareholder Campaigns	85
1.	What We Know About Activists and Their Targets	85
2.	What Do We Know About the Outcomes of Activist Campaigns?	88
3.	What Conclusions Can We Draw from Hedge Fund Activism?	94
C.	Takeovers	95
1.	What We Know About Takeovers	96
2.	What Do We Know About the Use of Takeover Defenses?	99
3.	What Conclusions Can We Draw from Takeovers?	105
IV.	CONCLUSION	106

THERE ARE TWO STORIES told about shareholders in corporate law. In the first story, a manager regularly finds himself in conflicts of interest, directors do little to restrain their worst impulses, and shareholders are the only plausible countervailing power. In the second story, shareholders lack the opportunities to become familiar with the unique circumstances of a company and have incentives that often conflict with the company’s long-term interests. The moral of this second story is precisely the opposite of the first: Boards must be given protection from shareholder power. The competition between these stories undergirds most of the current debates in corporate law: the merits of activist shareholders, proxy access, say-on-pay, the proper ends of corporate actors, how to maximise corporate social responsibility, the causes of the 2008 financial crisis, the value of the proxy advisory industry, decision-making in takeovers, and others.

Some of these debates can only be described as interminable.¹ Legal scholars have become so identified with one or another of these stories about shareholders

1. See Claire A Hill, “An Identity Theory of the Short- and Long-Term Investor Debate” (2018) 41 Seattle UL Rev 475 at 476 (arguing these debates will never be resolved because they “are complex questions, scarcely amenable to resolution by definitive evidence” and are wrapped in each side’s prior socially-constructed identity).

that they have maintained their position for entire academic careers.² They have witnessed the same frauds, economic shocks, corporate success stories, crises, and regulatory initiatives; finding their story vindicated at precisely the time their opponents find the opposite. Meanwhile, public policy cannot wait for scholarly consensus, and so legislative and regulatory changes reflect largely the first of these stories, with little apparent effort to explain why that story has been favoured and the merits of the other ignored. This article is an attempt to step back from the policy issues of the day and to look at the empirical evidence surrounding various forms of shareholder activism, asking what evidence exists for either story and whether the direction corporate law has taken over the past several decades is correct.

I. THE STORIES

What I am referring to as “stories” are, of course, economic models of shareholder behaviour. Like all models of economic behaviour, they leave out a great deal about the decision-making process they purport to describe, identifying only what the authors believe are the most essential and generalizable elements. For example, all the versions of the stories I am describing share the common assumption that shareholders, including fund managers, generally act to maximise their economic well-being. This is the familiar utility-maximising *homo economicus* from mainstream economic theory. In reality, shareholders are motivated by more than just their economic interests. They respond to the pull of moral obligations, a desire for self-expression, loyalty towards friends (some of whom may be running the companies in which they invest), and dozens of other impulses, quirks of personality, and social pressures.³

The measure of the quality of one of the stories I discuss is not, therefore, whether it seems to capture the richness and complexity of individual shareholder

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2. See Lucian A Bebchuk, “The Case for Increasing Shareholder Power” (2005) 118 Harv L Rev 833; Theodore Mirvis, “Bebchuk’s ‘Case for Increasing Shareholder Power’: An Opposition” (15 June 2007), online (blog): *Harvard Law School Forum on Corporate Governance* <corpgov.law.harvard.edu/2007/06/15/bebchuks-case-for-increasing-shareholder-power-an-opposition>; Lynn A Stout, “The Mythical Benefits of Shareholder Control” (2007) 93 Va L Rev 789; Stephen M Bainbridge, “Director Primacy and Shareholder Disempowerment” (2006) 119 Harv L Rev 1735. See also Anita Anand, *Shareholder-Driven Corporate Governance* (Oxford University Press, 2019) [Anand, *Corporate Governance*].
 3. I discuss the deviations of shareholder voting from economic self-interest. See Bryce C Tingle, “Expressive Voting and Irrational Outcomes in Corporate Elections” [forthcoming in 2021] [Tingle, “Expressive Voting”].

decision-making in the way of a novelist. Rather, the merit of the story is its usefulness: whether the story accurately describes and predicts shareholder behaviour in a range of circumstances across the market, and over prolonged periods of time.

I am using the term “stories,” rather than “models,” because the former better captures the ways in which these behavioural descriptions are actually used in discussions of corporate governance. They function as easily grasped moralizing narratives, often lacking the formal completeness we associate with models.⁴ For example, agency cost theory was introduced to the world as a partial equilibrium model, complete with crucial, explicit assumptions that made agent loyalty the only unsolved problem for the model.⁵ The existence of these complexities is largely ignored in current discussions of corporate governance, however, where the agency cost story is understood to be that corporate managers can be unreliable stewards of the shareholders’ property, and so shareholder authority and monitoring is needed as a disciplining force. It is in its capacity as a story, rather than a model, that agency cost theory operates in the background of discussions about corporate governance, influencing reform efforts and how certain kinds of market behaviour is understood.⁶ Similar points could be made about the other stories discussed in this article (such as the shareholder short-termism story).

A. THE GOOD SHAREHOLDER STORY

Like most debates in corporate law, the good shareholder story begins with Adolf Berle. Early in his academic career, Berle urged greater shareholder power as a countervailing force against corporate managers, but after witnessing the impact of the New Deal’s regulation of finance and imbibing its optimism about neutral

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4. See Kimberly Bates & Dean Hennessy, “Tilting at Windmills or Contested Norms? Dissident Proxy Initiatives in Canada” (2010) 18 CG 360 (referring to the way that in Canada, what I am referring to as the good shareholder story, “seems to have achieved a taken for grantedness, one sign of legitimacy” (*ibid* at 362)) [Bates & Hennessy, “Tilting at Windmills”]. For a recent Canadian example of agency cost theory operating in this way, see Anita Anand, “Implications of Shareholder Activism” in PM Vasudev & Susan Watson, eds, *Global Capital Markets* (Edward Elgar, 2017) 17 at 19 (arguing that merely the “possibility” that agents may entrench themselves should lead to regulatory and legislative increases in shareholder influence) [Anand, “Shareholder Activism”].
 5. See William W Bratton & Simone M Sepe, “Corporate Law and the Myth of Efficient Market Control” (2020) 105 Cornell L Rev 675 (discussing variables left out of Jensen and Meckling’s model); Kenneth Lehn, “Corporate Governance and Corporate Agility” (University of Pittsburgh Finance Group, 2019), online: <www.ssrn.com/abstract=3485307> (noting agility is left out of the model).
 6. See the text accompanying notes 8-24, below.

technocrats, he ended his career as a supporter of managers as a kind of non-state civil servant.⁷ “The shareholders, earlier thrown up...as a countervailing interest, dropped out of the governance picture.”⁸

Over the next few decades, very few academics paid much attention to the good shareholder story or to corporate governance generally.⁹ This began to change by the mid-1970s, when Michael Jensen and William Meckling’s “Theory of the Firm” influentially recast the field of corporate law as a place where principals (the shareholders) sought to reduce the costs imposed on them by their agents (directors and officers).¹⁰ This proved to be the most potent formulation of the good shareholder story and it came to exercise enormous influence over academics and regulators.¹¹

At its heart, the good shareholder story sees shareholders as a useful countervailing force against unreliable managers. It is the shareholders’ money, after all, that the managers may be wasting through excessive compensation, perquisites, empire building, or negligence. The most influential advocates of this story have pointed out how directors and officers have historically faced very little risk of being ousted in the wake of poor corporate performance—that shareholder power to replace directors was limited outside of the extreme step of launching a hostile takeover.¹² The lavish corporate perquisites and inefficient conglomerates of the time seemed to be a logical consequence of this excessive

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7. See William Bratton & Michael Wachter, “Shareholder Primacy’s Corporatist Origins: Adolf Berle and the ‘Modern Corporation’” (2008) 34 J Corp L 99; William Bratton & Michael Wachter, “Tracking Berle’s Footsteps: The Trail of The Modern Corporation’s Last Chapter” (2010) 33 Seattle UL Rev 849 [Bratton & Wachter, “Tracking Berle’s Footsteps”].
 8. Bratton & Wachter, “Tracking Berle’s Footsteps”, *supra* note 7 at 863.
 9. See Bryce C Tingle, “What is Corporate Governance? Can We Measure it? Can Investment Fiduciaries Rely on it?” (2018) 43 Queen’s LJ 223 [Tingle, “Can We Measure It?”].
 10. Michael C Jensen & William H Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976) 3 J Fin Econ 305.
 11. Tingle, “Can We Measure It?”, *supra* note 9 (noting “agency theory as described by Jensen and Meckling came to supply the theoretical coherence to corporate law that Bayless Manning complained was missing” (*ibid* at 229)). See also Randall S Kroszner & Louis Putterman, *The Economic Nature of the Firm: A Reader*, 3rd ed (Cambridge University Press, 2009). Kroszner & Putterman observe that over recent decades there is a growing frequency of references to the work of Michael Jensen and William Meckling: “The years that followed have seen those and related works serve as the core of a literature that has deepened in institutional detail, branched out into empirical studies, and inspired progress in formal analysis” (*ibid* at 1).
 12. See Lucian A Bebchuk & Jesse M Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004) at 43-44.

managerial power.¹³ “As the twentieth century drew to a close, senior executives were in charge of larger companies than their mid-twentieth century predecessors and had greater managerial latitude, meaning that there was more at stake for investors than ever before.”¹⁴

Influential academic articles advocating greater shareholder power over boards and managers began to be published in law journals with titles like “The Value of Institutional Investor Monitoring,”¹⁵ “Agents Watching Agents: The Promise of Institutional Investor Voice,”¹⁶ and “The Case for Increasing Shareholder Power.”¹⁷ The rise of the independent director in the modern corporate governance paradigm was explicitly linked to the goal of giving shareholders more influence over board decisions.¹⁸ This flood of articles was understood to arise from the growth of institutional investors in public markets, which created a new class of highly-educated professional fund managers, who were considerably more sophisticated than the retail investors they were displacing. The large holdings of institutional investors were also seen as providing incentives for those managers to actively engage in corporate governance rather than simply selling shares in poorly run companies, like previous generations of investors.¹⁹ In Canada, a law review article published in 1996 “found a statistically significant correlation between institutional ownership and both return on assets and return on equity,”

13. See Peter G Klein, “Were the Acquisitive Conglomerates Inefficient?” (2001) 32 RAND J Econ 745 at 747. See also Paul Boselie & Bas Koene, “Private Equity and Human Resource Management: ‘Barbarians at the Gate!’ HR’s Wake-up Call?” (2010) 63 Hum Rel 1297.

14. Brian Cheffins, “The Corporate Governance Movement, Banks, and the Financial Crisis” (2015) 16 Theor Inq L 1 at 6 [Cheffins, “Corporate Governance Movement”].

15. Bernard S Black, (1992) 39 UCLA L Rev 895.

16. Bernard S Black, (1992) 39 UCLA L Rev 811.

17. Bebchuk, *supra* note 2. See also Bernard S Black, “Institutional Investors and Corporate Governance: The Case for Institutional Voice” (1992) 5 J Applied Corp Fin 19; Mark J Roe, “A Political Theory of American Corporate Finance” (1991) 91 Colum L Rev 10.

18. Ronald Gilson & Reinier Kraakman, “Reinventing the Outside Director: An Agenda for Institutional Investors” (1991) 43 Stan L Rev 863. See also John C Coffee, “Liquidity Versus Control: The Institutional Investor as Corporate Monitor” (1991) 91 Colum L Rev 1277.

19. Joseph A McCahery, Zacharias Sautner & Laura T Starks, “Behind the Scenes: The Corporate Governance Preferences of Institutional Investors” (2016) 71 J Fin 2905 (while institutional investors hold that exit, or threat of exit, is a viable strategy, less than half would do so “because of dissatisfaction with performance (governance).” (*ibid* 2906-07) Intervention tactics in governance are a preferred first step, and the threat of exit serves as “complement to voice rather than a substitute” (*ibid* at 2907)).

which was explicitly linked by its author to the value of institutional investors as monitors of management.²⁰

The excitement around the good shareholder story never went away, but within a few years, it had moderated.²¹ Reflecting, for example, on Bernard Black's seminal article, "Agents Watching Agents," Sharon Hannes observed that the paper's predictions "did not fully materialize."²² Nevertheless, the story remains a potent force in the legal academy.²³ For example, in the most influential economics book of the new century, Thomas Piketty makes use of it in discussing how managers extract rents from shareholders.²⁴ One of the most recent works by a Canadian legal academic is titled, "Shareholder-Driven Corporate Governance," and argues that, "[i]n light of this sophistication [of institutional shareholders] and the meaningful input that shareholders can provide, it makes sense to allow shareholders greater scope for participation in the affairs of the corporation."²⁵

B. THE BAD SHAREHOLDER STORY

The bad shareholder story arose a little later than the good shareholder story in the context of the unprecedented wave of hostile, leveraged takeovers in the 1980s.²⁶ These tended to be very good for shareholders (at least those who were selling into the bid), but bad for a wide range of other constituencies. It was also an environment that brought the question of shareholder power into direct focus.

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20. Jeffrey G MacIntosh, "Institutional Shareholders and Corporate Governance in Canada" (1996) 26 Can Bus LJ 145 at 179.
 21. See Bernard S Black, "Shareholder Activism and Corporate Governance in the United States" in Peter Newman, ed, *The New Palgrave Dictionary of Economics and the Law* (Macmillan Reference, 1998) vol 3 at 459 (finding institutional shareholders spent a trivial amount of money on corporate governance and exercised few of the powers provided to them by corporate law). See also John C Coffee, "The SEC and the Institutional Investor: A Half-Time Report" (1994) 15 Cardozo L Rev 837.
 22. "Super Hedge Fund" (2015) 40 Del J Corp L 163 at 172. See also Ben W Heineman & Stephen Davis, "Are Institutional Investors Part of the Problem or Part of the Solution?" (October 2011), online (pdf): *Committee for Economic Development* <www.ced.org/pdf/Are-Institutional-Investors-Part-of-the-Problem-or-Part-of-the-Solution.pdf>.
 23. See e.g. George Dent, "Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance" (2008) 44 Hous L Rev 1213 at 1232; Steven A Ramirez, "The Special Interest Race to CEO Primacy and the End of Corporate Governance Law" (2007) 32 Del J Corp L 345 at 370.
 24. *Capital in the Twenty-First Century*, translated by Arthur Goldhammer (Belknap Press of Harvard University Press, 2014).
 25. Anand, *Corporate Governance*, *supra* note 2 at 5.
 26. See Diana L Fortier, "Hostile Takeovers and the Market for Corporate Control" (1989) 13 Econ Persp 2 at 3.

Should directors have the power to prevent a bid that was supported (as they nearly always were) by the firm's shareholders?²⁷

As it evolved, three distinct versions of the bad shareholder story came to be used by legal academics and other interested parties. The first focuses on the relative ignorance of shareholders in public markets. Shareholders lack the information necessary to make informed decisions about the firm, as much of this information is not public, and to collect it would require time and other resources that shareholders are unwilling to spend.²⁸ Shareholders entrust their capital to agents for a reason. In practice, it is easier for shareholders, even institutional investors, to simply exit the stock than to expend the resources necessary to engage in collective action.²⁹ In fact, fund managers are largely incentivised to improve their portfolios' relative, not absolute, performance, so institutional investors deliberately employ investment strategies broadly similar to their competitors. There is pressure not to behave in ways, such as embarking on activist corporate campaigns, that might make one an outlier.³⁰ These are the familiar "free-riding," "collective action," and "herding" problems.³¹

Whatever the merits of the bad shareholder story as a generalised description of institutional and retail investors, at least some types of investor—usually described as "activist" and often organised as a hedge fund—have created for themselves the economic incentives to collect the necessary information to

27. *Ibid.*

28. This position is most associated with Professor Stephen M Bainbridge. See Stephen M Bainbridge, "Director Primacy: The Means and Ends of Corporate Governance" (2003) 97 Nw UL Rev 547 [Bainbridge, "Means and Ends"]; Stephen M Bainbridge, "Director Primacy and Shareholder Disempowerment" (2006) 119 Harv L Rev 1735; Stephen M Bainbridge, "Director Primacy in Corporate Takeovers: Preliminary Reflections" (2002) 55 Stan L Rev 791; Stephen M Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press, 2009).

29. See Usha Rodrigues, "Corporate Governance in an Age of Separation of Ownership from Ownership" (2011) 95 Minn L Rev 1822 at 1830-31; Roberta Romano, "Institutional Shareholders and Corporate Governance in the US" in Geoffrey Owen, Tom Kirchmaier & Jeremy Grant, eds, *Corporate Governance in the US and Europe: Where Are We Now?* (Palgrave Macmillan, 2006); Lynne L Dallas, "Short-Termism, the Financial Crisis, and Corporate Governance" (2011) 37 J Corp L 264; Jill E Fisch, "Securities Intermediaries and the Separation of Ownership from Control" (2010) 33 Seattle UL Rev 877.

30. See Ronald J Gilson & Jeffrey N Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights" (2013) 113 Colum L Rev 863 at 893 [Gilson & Gordon, "Agency Costs"].

31. For a good overview of collective action and free-riding problems, see Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Harvard University Press, 1965). For a discussion of herding, see Andrea Devenow & Ivo Welch, "Rational Herding in Financial Economics" (1996) 40 Eur Econ Rev 603.

improve the quality of corporate management. Activist shareholders may be unable to make nuanced judgments about the business with the information available to them,³² but they cannot be ruled out on the *prima facie* grounds of a lack of motivation.³³

The second version of the story argues that, even if shareholders such as activist funds could properly inform themselves, their interests nevertheless conflict with those of the corporation.³⁴ Nearly all institutional investors compete for investment capital on the basis of their relative returns. Even an index fund, which does not actively pick stocks, will lose investors if it suffers too many quarters where it underperforms other funds. They are forced to compete with “[a]ctively managed mutual funds [which] attempt to beat the market by investing in stocks that appreciate faster than average.”³⁵ Thus, while the beneficial owners of financial funds (such as pension holders) may be investing for the long term, the fund managers themselves are very conscious of the need to consistently perform well in the short-run.³⁶

32. See Stephen M Bainbridge, *Corporate Governance after the Financial Crisis* (Oxford University Press, 2012) (noting “shareholders lack incentives to gather the information necessary to actively participate in decision making” (*ibid* at 238)) [Bainbridge, *Corporate Governance*].

33. See Alon Brav et al, “Hedge Fund Activism, Corporate Governance, and Firm Performance” (2008) 63 J Fin 1729 (noting “hedge funds are more flexible, incentivized, and independent than internal monitors, and they can generate multiple gains from targeting several companies on similar issues” (*ibid* at 1733)) [Brav et al, “Hedge Fund Activism”].

34. See Iman Anabtawi, “Some Skepticism About Increasing Shareholder Power” (2006) 53 UCLA L Rev 561 at 577-93; Kent Greenfield, “The Third Way” (2014) 37 Seattle UL Rev 749 at 750.

35. Rodrigues, *supra* note 29 at 1830.

36. For the most exhaustive treatment of these incentives, see Roger M Barker & Iris HY Chiu, *Corporate Governance and Investment Management: The Promises and Limitations of the New Financial Economy* (Edward Elgar, 2017) at 32-36 (“Making the Realisation of Investment Returns in a Business and Profit-Oriented Activity” specifically details short-term pressures impacting different types of investment funds); Martin Lipton & Stephen A Rosenblum, “A New System of Corporate Governance: The Quinquennial Election of Directors” (1991) 58 U Chicago L Rev 187; Jack B Jacobs, “Patient Capital: Can Delaware Corporate Law Help Revive it?” (2011) 68 Wash & Lee L Rev 1645 (noting “institutional investors are managed by persons or firms whose compensation depends on generating short-term returns from the portfolio company shares under fund management” (*ibid* at 1650)); Dallas, *supra* note 29 at 272; Andrei Shleifer & Robert Vishny, “Equilibrium Short Horizons of Investors and Firms” (1990) 80 Am Econ Rev 148 (noting “[b]oth fundamental and noise trader risk are more important for assets where the elimination of underpricing takes longer, since there is more time for bad news or a wave of pessimism to hit. These risks raise the cost of arbitraging long-term assets relative to short-term assets” (*ibid* at 151)).

In the 1950s, the average holding period for a share traded on the New York Stock Exchange (NYSE) was about seven years—now, it is about six months.³⁷ Mutual funds claim an annual turnover of about 100 per cent,³⁸ but a 2010 study by the Investor Responsibility Research Institute found that “nearly two-thirds of portfolio managers have higher annual portfolio turnover than claimed, some by as much as 200 per cent.”³⁹ Hedge funds trade at even faster rates.⁴⁰ It should be noted that shareholders are able to get out of company shares much faster than corporate managers who face black-out periods, powerful norms against insider sales, insider trading rules, and vesting and escrow provisions.

It follows from the short-term pressures on fund managers that they are quick to trade out of underperforming stocks, which (it is claimed) in turn puts pressure on corporate managers to sacrifice long-term value creation to burnish current operating metrics.⁴¹ This usually takes the form of earnings management. While occasionally this can shade into fraud (like Enron),⁴² it more commonly consists of real-world expense and investment decisions designed to improve short-term corporate performance. This can alter “the timing and scale of real activities such as production, sales, investment, and financing activities throughout the accounting period in such a way that a specific earnings target can be met.”⁴³ Long-term research and development (R&D) investments are

37. See Justin Fox & Jay W Lorsch, “What Good Are Shareholders?” (2012) 90 Harv Bus Rev 48 at 51.

38. See Jacobs, *supra* note 36 at 1651; James Hawley, Keith Johnson & Ed Waitzer, “Reclaiming Fiduciary Duty Balance” (2011) 4 Rotman Intl J Pension Mgmt 4.

39. *Ibid* at 5.

40. Hennessee Group LLC, Press Release, “Hennessee Releases 10th Annual Hedge Fund Manager Survey” (2004), online: <www.hennesseegroup.com/releases/release20040802.html>.

41. *Ibid*; Rodrigues, *supra* note 29 at 1829.

42. Bethany McLean & Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (Portfolio, 2013)

43. Jeong-Bon Kim & Byungcherl Charlie Sohn, “Real versus Accrual-Based Earnings Management and Implied Cost of Equity Capital” (Paper delivered at the Annual Conference of Canadian Academic Accounting Association, 26 May 2011) at 2, online: <www.ssrn.com/abstract=1297938>. See also William W Bratton & Michael L Wachter, “The Case Against Shareholder Empowerment” (2010) 158 U Pa L Rev 653 (noting “[o]nce management prioritizes meeting the market’s EPS expectations, investments that enhance long-term value but impair near-term earnings may be delayed or forgone” (*ibid* at 702)) [Bratton & Wachter, “Shareholder Empowerment”]; Thomas Lee Hazen, “The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and Corporate Law” (1991) 70 NCL Rev 137. This view, of course, runs contrary to strong versions of the Efficient Market Hypothesis, but empirical evidence suggests markets are less efficient than strong versions of the theory predict. See Stephen

often alleged to be particularly vulnerable.⁴⁴ Companies with a large percentage of high-turnover shareholders have overpaid for acquisitions, sold themselves at a discount in mergers, and generally underperformed the market.⁴⁵

Another possible conflict of interest arises from the character of investment funds as diversified portfolios of stocks. Modern Portfolio Theory (MPT) predominates as the investment strategy of most categories of institutional shareholders and is predicated on the notion that individual firm characteristics, such as their corporate governance arrangements, effectively cancel themselves out so that the portfolio as a whole reflects only market-wide or systemic risk.⁴⁶ As described by Professor Stephen Bainbridge, “Diversification eliminates unsystemic risk, because things tend to come out in the wash. One firm’s plant burns down, but another hits oil.”⁴⁷ Indeed, one of the arguments deployed to persuade investors to invest through institutional funds, rather than directly, is that these funds can provide a level of diversification impossible for the average investor.⁴⁸

Even if we are only prepared to accept a relatively weak version of MPT, a representative fund manager will nevertheless be much more interested in the risk-taking reflected across their portfolio as a whole than in the risk-taking in

F LeRoy, “Efficient Capital Markets and Martingales” (1989) 27 J Econ Literature 1583 (noting “[i]f price always equals fundamental value, then no profit can be earned by trading on a discrepancy between the two” (*ibid* at 1593)).

44. See Joern H Block, “R&D Investments in Family and Founder Firms: An Agency Perspective” (2012) 27 J Bus Venturing 248 at 249. Long-term investments in R&D may lead to an agency problem between the owners and the managers of a firm, as R&D spending and productivity change as new management follows investment capital.
45. See José-Miguel Gaspar, Massimo Massa & Pedro Matos, “Shareholder Investment Horizons and the Market for Corporate Control” (2005) 76 J Fin Econ 135 (noting “firms with higher investor turnover have a significantly higher chance of receiving an offer,” and short-term investors indicate “easier targets with lower bargaining power” (*ibid* at 149)).
46. See Gilson & Gordon, “Agency Costs,” *supra* note 30 at 867 (referencing the “intellectual triumph of modern portfolio theory, which promotes diversification as the touchstone investment strategy” (*ibid*)). See also Tingle, “Can We Measure It?,” *supra* note 9 at 258; Ronald J Gilson & Bernard S Black, (*Some of*) *The Essentials of Finance and Investment* (Foundation Press, 1993) at 95-97.
47. Tingle, “Can We Measure It?,” *supra* note 9 at 258.
48. See e.g. Ulrich Lossen, *Portfolio Strategies of Private Equity Firms: Theory and Evidence* (Deutscher Universitäts-Verlag, 2007).

a specific firm.⁴⁹ In theory, it is in the fund's interests for all of its portfolio companies to embark on risky strategies, as this should increase the returns of the portfolio as a whole, regardless of what this might mean for those portfolio companies whose bets do not pay off. For example, research on bank performance in the run-up to the financial crisis suggests that the more power institutional shareholders had over banks, the more likely the banks would have outsized profits before the crisis and larger losses during the crisis.⁵⁰ In contrast, banks more firmly under the control of their managers took fewer risks.

In the area of corporate governance, firm-specific investigation and activism are least likely to be undertaken by the managers of a diversified portfolio, as all of the costs will be borne by the fund (driving down its returns), but most of the gains will be limited by the fact of diversification.⁵¹ Indeed, most of the gains will be reflected in the performance of the competitors or the benchmarks that the fund measures itself against. In any event, corporate governance failures (and successes) are exactly the kind of firm-specific outcomes that a properly diversified portfolio is intended to render irrelevant.

Institutional shareholders have interests other than maximizing corporate value. This final version of the conflict of interest story observes that fund managers may feel they must demonstrate a proper commitment to certain political positions about carbon emissions, tobacco and alcohol, defense contractors, employment practices, and populist positions on executive compensation in order to please the constituencies (*i.e.*, politicians, labour executives, universities, politically-motivated individuals, et cetera) that retain them to manage their

49. Tingle, "Can We Measure It?", *supra* note 9. I observe that

even if a fund is well-diversified...corporate governance measures [as advocated by MPT] fail to predict investment outcomes, but viewed from the perspective of the entire portfolio, maybe this does not matter—the failures of the various indices might cancel each other out (*ibid* at 256-257).

50. See Nadia Saghi-Zedek & Amine Tarazi, "Excess Control Rights, Financial Crisis and Bank Profitability and Risk" (2015) 55 J Banking & Fin 361 at 371; Reint Gropp & Matthias Köhler, "Bank Owners or Bank Managers: Who is Keen on Risk? Evidence from the Financial Crisis" (Discussion Paper No 10-013, 2010), online (pdf): ZEW-ub-madoc.bib.uni-mannheim.de/2907/1/dp10013.pdf. See also Alan Dignam, "The Future of Shareholder Democracy in the Shadow of the Financial Crisis" (2013) 36 Seattle UL Rev 639 at 643-58.
51. See Ronald J Gilson & Jeffrey N Gordon, "Agency Capitalism: Further Implications of Equity Intermediation" in Jennifer G Hill & Randall S Thomas, eds, *Research Handbook on Shareholder Power* (Edward Elgar, 2015) 32 at 40-46 [Gilson & Gordon, "Agency Capitalism"].

money.⁵² Hedge funds may use recondite hedging strategies to profit from declines in the share value of companies they target (so-called empty voting) or to profit just from movements in the share price, regardless of its long-term direction.⁵³

It may also be in shareholders' interests to receive money in the form of stock buy-backs or dividends, even if this leads to weaker companies, less capital for investment, and prejudices the holders of fixed claims such as debt holders and employees. The most arresting development over the last fifty years is that, since 1962, American stockholders have withdrawn more money from corporations than they have invested.⁵⁴ As a result, corporate-retained earnings have declined from an average of approximately 50 to 60 per cent each year to three per cent between 1962 and 2002.⁵⁵ Long-term debt increased significantly as well. From 2002 to 2012, net issuance of corporate equity in the United States was negative \$287 billion—and this includes the frantic equity fundraising of financial institutions during the financial crisis.⁵⁶ As one scholar notes, "[t]here is little question that public equity largely has disappeared as a significant form of permanent capital."⁵⁷

The final version of the bad shareholder story argues that, even if shareholders were incentivised and able to collect the necessary information, and even if their interests were always aligned with the long-term interests of the corporation,

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52. See Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered" (1993) 93 Colum L Rev 795 at 803; Bainbridge, *Corporate Governance*, *supra* note 32 (noting "[p]ublic employee pension funds are vulnerable to being used as a vehicle for advancing political/social goals unrelated to shareholder interests generally" (*ibid* at 247)); Marleen O'Connor, "Labor's Role in the American Corporate Governance Structure" (2000) 22 Comp Lab L & Pol'y J 97 at 114.
 53. See Henry TC Hu & Bernard S Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership" (2006) 79 S Cal L Rev 811; Marcel Kahan & Edward B Rock, "Hedge Funds in Corporate Governance and Corporate Control" (2007) 155 U Pa L Rev 1021. See generally Shaun Martin & Frank Partnoy, "Encumbered Shares" (2005) 2005 U Ill L Rev 775 at 781-82. For real-world instances, see *e.g.* *High River Limited Partnership v Mylan Laboratories Inc*, 353 F Supp (2d) 487 (Pa Dist Ct 2005) (this case was voluntarily dismissed); BCE Inc, "BCE shareholders approve acquisition by Teachers', Providence Equity and Madison Dearborn" (21 September 2007), online: *Starkville Daily News* <business.starkvilledailynews.com/starkvilledailynews/news/read/3255622/bce_shareholders_approve_acquisition_by_teachers'>.
 54. See Lawrence E Mitchell, "Whose Capital; What Gains?" (July 2012) at 2, online (pdf): *Brookings* <www.brookings.edu/wp-content/uploads/2016/06/Whose-Capital-What-Gains.pdf>; William Lazonick, "Profits without Prosperity: Stock Buybacks Manipulate the Market and Leave Most Americans Worse Off" (2014) 92 Harv Bus Rev 46.
 55. *Ibid.*
 56. Fox & Lorsch, *supra* note 37 at 50.
 57. Mitchell, *supra* note 54 at 3.

it is just not efficient to run a business by way of shareholder democracy. As Chancellor Strine notes:⁵⁸

it might be...counterproductive for investors to turn the corporate governance process into a constant Model U.N. where managers are repeatedly distracted by referenda on a variety of topics proposed by investors with trifling stakes. Giving managers some breathing space to do their primary job of developing and implementing profitable business plans would seem to be of great value to most ordinary investors.

Corporate law centralises corporate decision-making in the board of directors (which, in turn, centralises it further in the office of the CEO). To do this, it provides the board with considerable discretion, which in turn requires limiting shareholder power.⁵⁹

C. THE TWO STORIES CONSIDERED

Both stories about shareholders are obviously true at least some of the time. There are imperial CEOs, negligent boards, and crusading shareholders, just as there are uninformed, but opinionated and self-interested, institutional investors. The question is which of the two stories forms a better basis for policy? Which of the two stories is true most often?

The two stories are not directly relevant to the well-trodden question of whether it is shareholders' or stakeholders' interests that should be reflected in the decisions of corporate agents. Rather, the stories are concerned only with how decision-making power is allocated within the corporation.⁶⁰ I have argued elsewhere that the stakeholder/shareholder debate over the content of fiduciary duties is of little practical importance.⁶¹ Even in Canada, where the Supreme Court has definitively resolved the debate in favour of stakeholders, there can be

58. Leo E Strine, "Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law" (2014) 114 Colum L Rev 449 at 475 [Strine, "Can We Do Better by Ordinary Investors?"].

59. For this argument, see Bainbridge, "Means and Ends", *supra* note 28; Stephen M Bainbridge, "The Case for Limited Shareholder Voting Rights" (2006) 53 UCLA L Rev 601; Jennifer Arlen & Eric Talley, "Unregulable Defenses and the Perils of Shareholder Choice" (2003) 152 U Pa L Rev 577; Margaret M Blair & Lynn A Stout, "A Team Production Theory of Corporate Law" (1999) 85 Va L Rev 247.

60. For a recent discussion of this distinction, see David Millon, "Radical Shareholder Primacy" (2013) 10 U St Thomas LJ 1013.

61. Bryce C Tingle & Eldon Spackman, "Do Corporate Fiduciary Duties Matter?" (2019) 4 Annals Corp Governance 272 [Tingle, "Fiduciary Duty"]. See also Michael C Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (2010) 22 J Applied Corp Fin 32 at 40.

no objection to permitting shareholders a leading role in corporate governance, provided that doing so maximises the welfare of corporate stakeholders as a whole.⁶²

II. THE IMPACT OF THE TWO STORIES

The good shareholder story has always dominated the legal academy. There was an eruption of articles in the early 1990s using the good shareholder story as a framework to call for greater shareholder power in corporate governance.⁶³ Henry Hansmann and Reinier Kraakman's influential 2001 article, "The End of History for Corporate Law," essentially declared that the privileged position that scholars gave shareholders in corporate governance was now the only view occupying the field.⁶⁴ While there have been dissenting voices pointing out the faddishness of corporate law scholarship in this regard,⁶⁵ the good shareholder story (in the form of agency cost theory) is "the dominant framework of analysis for corporate law and corporate governance today."⁶⁶

62. See *BCE Inc v 1976 Debentureholders*, 2008 SCC 69 at paras 37, 42 [*BCE v Debentureholders*].

63. See text accompanying notes 11-16, above. See also Annette B Poulson, "Strong Managers, Weak Owners: The Political Roots of American Corporate Finance by Mark J Roe" (1995) 50 J Fin 764; Bernard S Black, "Shareholder Passivity Reexamined" (1990) 89 Mich L Rev 520; Edward B Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 Geo LJ 445; Romano, *supra* note 52; Robert D Rosenbaum, "Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes" (1991) 17 J Corp L 163.

64. (2001) 89 Geo LJ 439. The privileged position widely afforded to shareholders is referred to as the "shareholder-oriented model" or "standard model," with the author noting that "this consensus on the appropriate conduct of corporate affairs is also a consensus as to the appropriate content of corporate law, and it is likely to have profound effects on the structure of that law" (*ibid* at 441). In Canada, Anita Anand has written a series of articles supporting "a new concept of governance" called "Shareholder-driven Corporate Governance." See e.g. Anita Indira Anand, "Shareholder-Driven Corporate Governance and its Necessary Limitations: An Analysis of Wolf Packs" (2019) 99 BUL Rev 1515 at 1518.

65. See e.g. Douglas M Branson, "The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance" (2001) 34 Cornell Intl LJ 322 (criticizing those "scholars [who] wrote about, and subsequently oversold, institutional investor activism" (*ibid* at 322)).

66. Michael Klausner, "Fact and Fiction in Corporate Law and Governance" (2013) 65 Stan L Rev 1325 at 1326 [Klausner, "Fact and Fiction"]. See also Zohar Goshen & Richard Squire, "Principal Costs: A New Theory for Corporate Law and Governance" (2017) 117 Colum L Rev 767 (noting "the subject of most corporate law scholarship is the conflict of interests between managers...and shareholders. Scholars almost invariably conceptualize this conflict in terms of agency costs" (*ibid* at 775)); Boris Durisin & Fulvio Puzone, "Maturation of Corporate Governance Research, 1993-2007: An Assessment" (2009) 17 CG 266 (noting that, after conducting an extensive literature review, "[c]orporate governance theorizing is dominated by the agency approach. The results of our study clearly provide evidence both based on the citation as well as the co-citation analysis. The most influential works are proponents of agency theorizing and their influence increases over time" (*ibid* at 274)).

The legal regime swiftly followed the scholarly consensus. As one professor noted, “[t]he hope of reducing agency costs through institutional activism has led to regulatory and structural changes to increase shareholder power.”⁶⁷ Another professor noted that the good shareholder story arose at a time where the “politically relevant middle class” came to increasingly depend on the securities market to plan for retirement.⁶⁸ The regulatory emphasis on shareholder empowerment was thus an attempt by politicians and regulators to improve market returns in the ways suggested by the good shareholder story. “[C]hanges in the pension system helped to transform corporate governance into a system dominated by the shareholder interest.”⁶⁹

These changes have not occurred at the level of corporate law, narrowly considered. Indeed, even with the recent proposed amendments to the *Canada Business Corporations Act* (CBCA),⁷⁰ shareholder control rights provided by Canadian and American incorporation statutes are still “so weak that they scarcely qualify as part of corporate governance.”⁷¹ Instead, the increases in shareholder power have occurred as a result of securities regulators and other parties displacing corporate law.⁷² These non-governmental third parties include stock exchanges, proxy advisors, and a large governance “industry” comprised of media

67. Fisch, *supra* note 29 at 884.

68. Martin Gelter, “The Pension System and the Rise of Shareholder Primacy” (2013) 43 *Seton Hall L Rev* 909 at 910-11.

69. *Ibid* at 911.

70. Bill C-25, *An Act to amend the Canada Business Corporations Act, the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act and the Competition Act*, 1st Sess, 42nd Parl, 2018, c 8, cl 13(1) (assented to 1 May 2018) [Bill C-25]. Proposed amendments to the CBCA include majority voting for directors of distributing corporations.

71. Stephen M Bainbridge, “Director v. Shareholder Primacy in the Convergence Debate” (2002) 16 *Transnat’l Law* 45 at 48. See also Stephanie Ben-Ishai, “A Team Production Theory of Canadian Corporate Law” (2006) 44 *Alta L Rev* 299 (arguing that Canada exceeds the United States in conferring primacy on boards of directors); Anand, “Shareholder Activism”, *supra* note 4 at 20.

72. See Sean Vanderpol & Edward J Waitzer, “Addressing the Tension Between Directors’ Duties and Shareholder Rights—A Tale of Two Regimes” (2012) 50 *Osgoode Hall LJ* 177 (noting “[t]he securities commissions have, “[t]hrough their willingness to use their ill-defined public interest jurisdiction to intervene in corporate transactions...displaced corporate law and its focus on the statutory duties of directors”” (*ibid* at 209)).

outlets, think tanks, academics, and pressure groups.⁷³ This has happened before. As historians of corporate law have pointed out in the context of the separation of ownership and control in the early twentieth century, corporate law tends to follow, rather than lead, changes in corporate governance practices and norms.⁷⁴

The recent changes to the *CBCA* are a case in point. They require that the directors of distributing corporations be elected every year (rather than giving firms the option of three-year terms), that directors be voted on individually rather than as part of a slate, and that a director is only elected if supported by a majority of votes cast.⁷⁵ This means that a director is removable from office, not just when beaten by an actual human candidate with a platform of well-thought-out views, but through what amounts to a costless recall vote. However, nearly all of these rights were already provided to shareholders by the Toronto Stock Exchange (TSX) in 2014.⁷⁶ The effect of the *CBCA* amendments is to remove the last scrap of discretion held by the board, under the TSX rules, over whether to accept the resignation of a director who fails to meet the majority vote criteria.

The market for corporate control has grown steadily more powerful as well—a result of easy financing conditions combined with the decision by securities regulators to give ultimate authority to shareholders (rather than boards) by prohibiting takeover defenses.⁷⁷ While never available in Canada, the use of staggered (or “classified”) boards in the United States has almost disappeared

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73. See Paul Rose, “The Corporate Governance Industry” (2007) 32 J Corp L 887; Cheffins, “Corporate Governance Movement”, *supra* note 14 at 5, citing “Moves to Halt Another Decade of Excess” *Financial Times* (5 August 1999) at 10. In Canada the corporate governance industry includes proxy advisors such as Institutional Shareholder Services (ISS), advocacy organizations such as the Canadian Foundation for Advancement of Investor Rights (FAIR), Mouvement d’éducation et de défense des actionnaires (MEDAC), the Canadian Coalition of Good Governance (CCGG), think tanks such as Queen’s CPA Centre for Governance & Accountability, the University of Toronto’s David and Sharon Johnston Centre for Corporate Governance Innovation, and media initiatives such as Globe & Mail’s annual “Board Games” feature.
 74. See e.g. Alessio M Paces, “How Does Corporate Law Matter? ‘Law and Finance’ and Beyond” in Michael Faure & Jan Smits, eds, *Does Law Matter? On Law and Economic Growth* (Intersentia, 2011) at 324. See also Brian R Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford University Press, 2008).
 75. Bill C-25, *supra* note 70.
 76. “TSX Company Manual” (4 June 2020) at Part IV, ss 461.3, 461.4, online: *Toronto Stock Exchange* <www.tsx.com/w/tsx/tsxcm-en>. Majority voting policies had already been widely adopted on a voluntary basis, but in 2014 they became mandatory for all TSX companies.
 77. See *National Instrument 62-104: Take-Over Bids and Issuer Bids*, 9 May 2016, online (pdf): *Ontario Securities Commission* <www.osc.gov.on.ca/documents/en/Securities-Category6/ni_20160509_62-104_unofficial-consolidation.pdf>.

as a result of pressure by activists.⁷⁸ Poison pills have, for the same reason, also been disappearing in that country.⁷⁹ This has left boards with so little power over the sale decision that hostile bids have declined sharply in the era of the good shareholder story.⁸⁰ American boards now, generally, refer the sale decision to the shareholders.

Independent directors have come to dominate Canada's corporate boards over the past thirty years.⁸¹ While there is no evidence that they improve corporate performance (and some evidence that they make it worse for certain types of companies), independent directors do give shareholders more power.⁸² They have less at stake when a disagreement about strategy arises with a powerful investor. Concerned primarily about their reputation—which, in practice, means the regard in which they are held by the institutional investor community— independent directors are less inclined to potentially offend shareholders than the insiders who once formed a large part of Canada's corporate boards.⁸³ Independent directors are also more vulnerable to investor action, as shareholders can vote against directors, but cannot fire executives. The move to create wholly independent board committees over remuneration, nomination, governance, sales transactions, and financial reporting has magnified this channel of shareholder influence. The growth of independent board chairs has done so as well.⁸⁴

Possibly the most consequential factor in increasing shareholder power is the rise of third-party proxy advisory firms like Glass-Lewis and Institutional

78. See *Spencer Stuart Board Index US* (2019), online: (pdf): < www.spencerstuart.com/-/media/2019/ssbi-2019/us_board_index_2019.pdf > at 15 [SSBI-US].

79. See Guhan Subramanian, "A New Era for Raiders" (2010) 88 *Harvard Business Rev* 34 at 34; Mark D Gerstein et al, "The Resilient Rights Plan: Recent Poison Pill Developments and Trends" (July 2014) at 2, online (pdf): *Latham & Walkins* <www.lw.com/thoughtLeadership/2014-poison-pill-developments-and-trends> (using data from SharkRepellent.net). See also Lucian Arye Bebchuk, John C Coates & Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants" (2002) 55 *Stan L Rev* 885.

80. Strine, "Can We Do Better by Ordinary Investors?," *supra* note 58 at 470-71.

81. SSBI-US *supra* note 78 (noting that a significant majority (81 per cent) of *CSSBI 100* board members were independent in 2018, as defined by the Canadian Securities Administrators (*ibid* at 2, 30)).

82. See Bryce C Tingle, "What Do We Really Know About Corporate Governance? A Review of the Empirical Research Since 2000" (2017) 59 *Can Bus LJ* 292 at 296-302 [Tingle, "Corporate Governance Empirical Research"].

83. *Ibid.* See also Fox & Lorsch, *supra* note 37 (noting "[i]t's a rare businessperson who relishes a contentious election campaign" (*ibid* at 57)).

84. Tingle, "Corporate Governance Empirical Research" *supra* note 82.

Shareholder Services.⁸⁵ They devote unprecedented resources to corporate governance questions, pressure companies to adopt shareholder friendly policies,⁸⁶ punish directors for taking certain actions without shareholder approval (even when this approval is not required by any regulator),⁸⁷ and serve as a method of coordinating shareholder action by crystallizing significant voting blocks around their recommendations.⁸⁸ Combined with the rise of activist institutional investors during the period we are considering,⁸⁹ proxy advisors have significantly increased the influence of shareholder sentiment in the boardroom. Studies have shown boards even take actions they believe will be value-destroying to avoid violating a proxy advisor's guidelines⁹⁰ or to deflect an activist investor's attention.⁹¹

These changes have combined with a shift in the norms in capital markets. The good shareholder story is so widely believed that even conscientious directors, who have never personally encountered a malfeasant manager, understand their jobs to consist primarily of monitoring management and responding to shareholder opinion.⁹² This attitude did not change, even after the Supreme Court adopted a stakeholder model of the corporation in *BCE Inc. v. 1976 Debentureholders*.⁹³

Shareholder power in corporate governance arrangements has also grown significantly through informal channels. Surveys suggest that over two-thirds of

85. See Bryce C Tingle, "The Agency Cost Case for Regulating Proxy Advisory Firms" (2016) 49 UBC L Rev 725 [Tingle, "Agency Cost Case"]. See also Bryce C Tingle, "Bad Company! The Assumptions behind Proxy Advisors' Voting Recommendations" (2014) 37 Dal LJ 709 [Tingle, "Bad Company"].

86. See Martin Lipton, "Some Thoughts for Boards of Directors in 2015" (2 December 2014), online (blog): *Harvard Law School Forum on Corporate Governance* <www.corpgov.law.harvard.edu/2014/12/02/some-thoughts-for-boards-of-directors-in-2015>. ISS' bias is evident, for example, in its recommendation to "withhold/against votes if the board amends the company's bylaws or charter without shareholder approval in a manner 'that materially diminishes shareholders' rights or that could adversely impact shareholders'" (*ibid*).

87. Tingle, "Bad Company", *supra* note 85 at 731-2.

88. *Ibid* at 745. See also Tingle, "Agency Cost Case", *supra* note 85.

89. See Iris H-Y Chiu, *The Foundations and Anatomy of Shareholder Activism* (Hart, 2010) chs 1-2. See also Brian R Cheffins & John Armour, "The Past, Present, and Future of Shareholder Activism by Hedge Funds" (2011) 37 J Corp L 51; Anand, "Shareholder Activism", *supra* note 4.

90. See Kenneth L Altman & James F Burke, *Proxy Advisory Firms: The Debate Over Changing the Regulatory Framework* (The Altman Group, 2011).

91. See Rita D Kosnik, "Greenmail: A Study of Board Performance in Corporate Governance" (1987) 32 Admin Science Q 163. See also B Espen Eckbo, "Valuation Effects of Greenmail Prohibitions" (1990) 25 J Fin Quantitative Analysis 491.

92. Tingle, "Bad Company", *supra* note 85 at 725-26.

93. *BCE v Debentureholders*, *supra* note 62. See also Tingle, "Fiduciary Duty", *supra* note 61; Carol Liao, "A Canadian Model of Corporate Governance" (2014) 37 Dal LJ 559.

directors believe activism has resulted in their companies altering their operations and capital allocation.⁹⁴ Activist institutions also regularly persuade boards to take strategic steps or accept new directors without any public notice. As a respected scholar observes, “since the mid-2000s... management has responded to shareholder demands as never before.”⁹⁵

Academic attempts to score investor protection measures and track their change over time find that, “without exception, all countries have increased the level of shareholder protection.”⁹⁶ The most extensive and rigorous attempt to measure the growth of shareholder power in the era we are considering finds a sharp increase in shareholder power through every channel that Pavlos Masouros examines.⁹⁷ After carefully arguing for the variables he includes in scoring the growth of shareholder power, he observes that the “natural” trend of the major Western economies “is persistently moving towards shareholder empowerment.”⁹⁸ In light of this growing power, Marcel Kahan and Edward Rock argue that CEOs are so hedged and second-guessed that they can only be described as “embattled.”⁹⁹

III. EMPIRICAL EVIDENCE ABOUT THE STORIES

This article looks at the empirical literature around the three most costly types of shareholder interventions in the management of a firm: shareholder proposals, activist campaigns, and takeovers. These are all moments when, in contrast with passive voting, shareholders take action, placing money and other resources behind their governance bets. They thus form the best context in which to evaluate the merits of the two stories about shareholders.

The merits of the stories are explicitly tied to the economic outcomes of the stories themselves. The good shareholder story we are evaluating, for example,

94. See Governance Insights Center, “The Swinging Pendulum: Board Governance in the Age of Shareholder Empowerment” (October 2016) at 11, 25, online (pdf): *PwC Global* <www.lexis securitiesmosaic.com/gateway/sec/speech/assets_pwc-2016-annual-corporate--directors-survey.pdf>. 71% claimed “activism has resulted in companies improving their operations and capital allocation” (*ibid* at 14).

95. Klausner, “Fact and Fiction”, *supra* note 66 at 1361.

96. Simon Deakin, Prabirjit Sarkar & Mathias Siems, “Is There a Relationship Between Shareholder Protection and Stock Market Development?” (2018) 3 *JL Fin & Acct* 115 at 123.

97. *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies* (PhD Dissertation, Leiden University, 2012) at 215-22.

98. *Ibid* at 301.

99. “Embattled CEOs” (2010) 88 *Tex L Rev* 987.

is not that shareholders care about social and environmental measures that managers would just as soon ignore; it is that wealth will be maximised if agency costs are controlled. Similarly, the bad shareholder story is not that shareholders are only interested in total return regardless of the harm it causes to other constituencies. Rather, it argues that shareholder interventions in governance are value-destroying. Arguments about the corporate governance arrangements that are best for, say, the environment or organised labour, are interesting, but they are not the subject of this article.¹⁰⁰ Helpfully, the vast majority of empirical research over the past few decades on different types of shareholder interventions reflects the economic focus of the two stories, usually through examining the outcomes of shareholder interventions in terms of share value, executive pay, CEO turnover, and various measures of financial operating performance.¹⁰¹

Most of the empirical research on these interventions—and corporate governance generally—makes use of US data.¹⁰² To take one example of particular relevance to this article, Professor Brian Cheffins notes “a lack of Canadian-specific data...on the impact that hedge fund activism has on corporate performance and shareholder returns.”¹⁰³ In contrast, as we shall see, there are dozens of good studies on this topic in the United States.¹⁰⁴ Nearly all of what follows, therefore, makes use of empirical studies conducted in American markets.

100. For an example of a recent work on shareholder activism that explicitly ignores (or “transcends”) economic consequences, see Lisa M Fairfax, “Social Activism Through Shareholder Activism” (2019) 76 Wash & Lee L Rev 1129. See also Aaron A Dhiri, “Realigning the Corporate Building Blocks: Shareholder Proposals as a Vehicle for Achieving Corporate Social and Human Rights Accountability” (2006) 43 Am Bus LJ 365.

101. See e.g. David Larcker & Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and their Consequences* (Pearson, 2015) (summarizing economic research on a range of corporate governance topics).

102. Durisin & Puzone, *supra* note 66 (finding “most empirical research in the leading academic research journals is still done in a US institutional context” (*ibid* at 279)). See also Angela Morgan & Jack Wolf, “Approval of Shareholder-Sponsored Proposals: Evidence from Canada” (2007) 16 Intl Rev Fin Analysis 136 (noting “little is known about voting at firms incorporated outside of the United States” (*ibid* at 136)); Shamsud D Chowdhury & Eric Zengxiang Wang, “Institutional Activism Types and CEO Compensation: A Time-Series Analysis of Large Canadian Corporations” (2009) 35 J Mgmt 5 (noting “[p]revious research on CEO compensation has overwhelmingly focused on large U.S. corporations. For many countries, including Canada, only limited empirical evidence exists on emerging governing mechanisms, such as institutional ownership” (*ibid* at 7)).

103. “Hedge Fund Activism Canadian Style” (2014) 47 UBC L Rev 1 at 5 [Cheffins, “Hedge Fund Activism”].

104. See text accompanying notes 111-23, below.

Even though most of the academic writing about corporate governance appears in the American context, there is nothing about the two stories that is unique to that context. At their most basic, the two stories are about economic incentives and the resulting behaviour of shareholders and managers. The relevant legal rules that give rise to these competing incentives are those that produce the separation of ownership and control in the modern widely-held corporation. These rules are essentially identical in Canada and the United States.¹⁰⁵ Similarly, to the extent that the separation of ownership and control in investment funds matters for some versions of the bad shareholder story, there are no relevant differences in fund structures between the two countries.

The market actors in these two countries are also, in many cases, the same people.¹⁰⁶ About 30 per cent of TSX-listed companies are also American issuers, by reason of cross-listing on a US stock exchange.¹⁰⁷ Even Canadian firms that are not listed on US markets voluntarily adopt US corporate governance practices, either out of a conviction that they are superior, or in order to appeal to prospective investors in the deeper capital pools south of the border.¹⁰⁸ American shareholders are an important constituency in Canadian capital markets, especially in the areas we are considering. In one study of sixty-two hedge funds that engaged in activist campaigns in Canada, forty-two were based in the United States.¹⁰⁹ Tellingly, Professor Cheffins's paper on "Canadian Style" shareholder activism mostly describes the campaigns of American-based hedge funds in this country.¹¹⁰

105. See *e.g.* Bates & Hennessy, "Tilting at Windmills", *supra* note 4 (noting "Canada shares many features of its governance environment with other members of the Anglo-American sphere," and "[m]any changes in Canadian practices are similar to those in other parts of the Anglo-American sphere, and are consistent with the institutionalization of the agency problem in other developed countries as well" (*ibid* at 361)). See also Kimberly A Bates & Dean A Hennessy, "Does Convergence in Regulation Lead to Convergence in Practice? The Case of Dissident Proxy Contests in Canada" in Abdul A Rasheed & Toru Yoshikawa, eds, *The Convergence of Corporate Governance: Promise and Prospects* (Palgrave MacMillan, 2012) 49 at 50 [Bates & Hennessy, "Convergence"].

106. See Bates & Hennessy, "Tilting at Windmills", *supra* note 4 at 361.

107. See Atreya Chakraborty, Lucia Gao & Shahbaz Sheikh, "Corporate Governance and Risk in Cross-Listed and Canadian Only Companies" (2019) 57 Mgmt Decision 2740.

108. See Anita Anand, Frank Milne & Lynette D Purda, "Voluntary Adoption of Corporate Governance Mechanisms" (29 April 2006), online (pdf): *University of Toronto* <[tspace.library.utoronto.ca/bitstream/1807/88105/1/Anand%20Voluntary%20Adoption.pdf](https://utoronto.ca/bitstream/1807/88105/1/Anand%20Voluntary%20Adoption.pdf)>.

109. See Dionysia Katelouzou, *Hedge Fund Activism, Corporate Governance and Corporate Law: An Empirical Analysis Across Twenty-Five Countries* (PhD Dissertation, University of Cambridge, 2012), [unpublished] [on file with author] at 97-98, 100.

110. Cheffins, "Hedge Fund Activism", *supra* note 103.

A. SHAREHOLDER PROPOSALS

Shareholder proposals are the least costly means of shareholder intervention, and though they are only advisory in nature, boards tend to implement proposals that win the support of a majority of the shareholders.¹¹¹ For this reason, the proposal mechanism has emerged in the last decade or so as a focus of corporate reformers, who wish to expand its availability and scope.¹¹²

1. WHAT DO WE KNOW ABOUT SHAREHOLDER PROPOSALS?

The vast majority of proposals in the United States are made by individuals, and they are nearly always the same individuals making the same proposal to a wide spectrum of firms.¹¹³ In one year, the *New York Times* reported that just three individual investors and their families accounted for over 70 per cent of all proposals.¹¹⁴ Canada presents a similar profile with a very small number of institutions and individuals making nearly all the shareholder proposals in a representative period.¹¹⁵ Among institutional investors, only public pension funds and union funds are significant sources of shareholder proposals.¹¹⁶ Mutual funds are reflective of the for-profit investment industry generally; they initiated fewer than 1 per cent of the proposals in a representative proxy season.¹¹⁷ As Roberta Romano points out, the fact that the sponsors of most proposals are not private-sector funds competing for investor dollars, and that they have

111. See Yonca Ertimur, Fabrizio Ferri & Stephen R Stubben, "Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals" (2010) 16 J Corp Fin 53.

112. Bebchuk, *supra* note 2 at 872. For a similar argument in a Canadian context, see Jackie Cook & Kevin Thomas, "Canadian Shareholder Proposals Help Lead Governance Innovations", *The Globe and Mail* (16 August 2017), online: <www.theglobeandmail.com/report-on-business/rob-commentary/canadian-shareholder-proposals-help-lead-governance-innovations/article36003708>.

113. See Nickolay Gantchev & Mariassunta Giannetti, "The Costs and Benefits of Shareholder Democracy" (December 2018) European Corporate Governance Institute Finance Working Paper No 586/2018 at 12-13, online (pdf): <www.ecgi.global/sites/default/files/working_papers/documents/finalgantchevgiannetti.pdf> [Gantchev & Gianetti 2018].

114. See Stephen Davidoff Solomon, "Grappling With the Cost of Corporate Gadflies", *The New York Times* (19 August 2014), online: <dealbook.nytimes.com/2014/08/19/grappling-with-the-cost-of-corporate-gadflies>.

115. See Jun Yang, Eric Zengxiang Wang & Yunbi An, "Canadian Exceptionalism: Shareholder Proposals, Filer Identities, and Voting Outcomes" (2012) 38 Managerial Fin 456 at 463 (finding 83 per cent of all proposals from institutions are submitted by only five bodies and 86 per cent of proposals from individuals came from just three individuals).

116. See Gilson & Gordon, "Agency Costs", *supra* note 30 at 887-88.

117. *Ibid* at 887.

political masters with non-economic interests, is suggestive of “private benefits” accruing to the sponsoring institutions.¹¹⁸ Studies find, for example, that “[l]abor unions appear to use shareholder proposals to enhance their bargaining position during contract negotiations.”¹¹⁹ Other studies find that public pension funds and labour funds disproportionately target Republican-leaning firms (measured by firms’ campaign contributions).¹²⁰

According to Proxy Monitor, in the ten-year period prior to 2016, social issues made up almost 40 per cent of shareholder proposals.¹²¹ Generally, these sorts of proposals tend to attract very little support from other shareholders.¹²² In contrast, corporate governance-related proposals, in most years the largest category of proposal, attract an average of 35.9 per cent support.¹²³ The vast majority of these proposals are made by persons unlikely to have the resources to analyze dozens of companies, so they “make one-size-fits-all proposals” about “corporate governance provisions that they have no experience in evaluating,” and that, if adopted, “seem to be ill-conceived.”¹²⁴ In fact, between 2003 and 2014, proposals that appeared “generic” (45 per cent), “unfocused” (76 per cent), or “faddish” (30 per cent) made up the vast majority of proposals received by

118. “Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance” (2001) 18 Yale J Reg 174 at 231.

119. John G Matsusaka, Oguzhan Ozbas & Irene Yi, “Opportunistic Proposals by Union Shareholders” (2015) University of Southern California Law School Working Paper No 177 at 1, online (pdf): *Bepress Legal Repository* <law.bepress.com/cgi/viewcontent.cgi?article=1313&context=usclwps-lss>.

120. Geeyoung Min & Hye Young You, “Active Firms and Active Shareholders: Corporate Political Activity and Shareholder Proposals” (2019) 48 J Leg Stud 81.

121. James R Copland & Margaret M O’Keefe, “Proxy Monitor Report: A Report on Corporate Governance and Shareholder Activism” (2016), online: <www.proxymonitor.org/Forms/pmr_13.aspx> (noting in 2016, half of all proposals included social or policy concerns: “The 50% of shareholder proposals involving social or policy issues is up from 42% in 2015 and 39% in the broader 2006-15 period” (*ibid*)).

122. Min & You, *supra* note 120 at 109. See also Eugene Soltes, Suraj Srinivasan & Rajesh Vijayaraghavan, “What Else do Shareholders Want? Shareholder Proposals Contested by Firm Management” (2017) Harvard Business School Working Paper No 16-132 at 25, online: <www.ssrn.com/abstract=2771114> (finding in their dataset that “none of the contested social/environmental proposals...win approval by shareholders” (*ibid*)).

123. Min & You, *supra* note 120 at 108-09.

124. Nickolay Gantchev & Mariassunta Giannetti, “The Costs and Benefits of Shareholder Democracy: Gadflies and Low-Cost Activism” (August 2020) European Corporate Governance Institute Finance Working Paper No 586/2018 at 2, online (pdf): <ecgi.global/sites/default/files/working_papers/documents/gantchevgiannettifinal_0.pdf> [Gantchev & Giannetti 2020].

firms in the Standard & Poor's 1500 index.¹²⁵ In most years, fewer than 20 per cent of shareholder proposals put to the vote attract majority support.¹²⁶ The few studies performed in Canada find that the nature of proposals in this country are broadly similar, as is their failure to obtain majority support.¹²⁷ In fact, the average and median voting support for a Canadian shareholder proposal is less than half that in the United States.¹²⁸

Shareholder proposals are aimed at large companies, which makes sense since most proposals (whether relating to governance or social issues) are not firm-specific but intended to effect a kind of political change (including changing market norms).¹²⁹ Targeting the highest profile firms provides for maximum impact. In Canada, one study found that "the majority of the shareholder proposals are filed at a few major Canadian banks (almost all other proposals also target well-known large Canadian companies)."¹³⁰ Looking at the relative profitability of Canadian targets of shareholder proposals, the authors found no connection between stock market performance and proposals: "Canadian

125. Gantchev & Giannetti 2018, *supra* note 113 at 37, table 5.

126. See Sullivan & Cromwell LLP, "2013 Proxy Season Review" (2 July 2013) at 2, online (pdf): <www.sullcrom.com/siteFiles/Publications/SC_Publication_2013_Proxy_Season_Review.pdf> (reporting 44/358, 12.29 per cent in 2013); James R Copland & Margaret M O'Keefe, "Proxy Season Preview: Shareholder Activism *en Marche*" (2017), online: <www.proxymonitor.org/Forms/pmr_14.aspx> (noting "[i]n 2016, 7% of shareholder proposals received majority shareholder support, down from 11% in 2015 but up from 4% in 2014" (*ibid*)).

127. Morgan & Wolf, *supra* note 102 (while the authors put a great deal of emphasis on the fact that there is no evidence of takeover-related proposals in Canada, this is merely a consequence of the decision of securities regulators to prohibit defenses that prevent a bid from being considered by the shareholders, rather than the result of any cultural or economic difference); Yang, Wang & An, *supra* note 115 (finding similarly few differences in the nature and popularity of contested proposals between Canada and the United States). See also Evaristus Oshionebo, "Shareholder Proposals and the Passivity of Shareholders in Canada: Electronic Forums to the Rescue?" (2012) 37 Queens LJ 623.

128. Yang, Wang & An, *supra* note 115 at 465. The authors note that more than half of Canadian proposals in the sample are withdrawn and, in many cases, this might be because a full or partial compromise was reached with managers. About half of these withdrawn proposals are on social, ethical, or environmental issues that do not focus on economic outcomes and that attract the lowest support in shareholder votes (*ibid* at 467). Cf Bates & Hennessy, "Convergence", *supra* note 105 at 52 (finding that only 27 per cent of Canadian proxy initiatives are withdrawn following negotiation).

129. See e.g. Fabrizio Ferri & Tatiana Sandino, "The Impact of Shareholder Activism on Financial Reporting and Compensation: The Case of Employee Stock Options Expensing" (2009) 84 *Acct Rev* 433; Ertimur, Ferri & Stubben, *supra* note 111; Gantchev & Giannetti 2018, *supra* note 113 at 14.

130. Yang, Wang & An, *supra* note 115 at 461.

shareholder proposals are primarily social activism in nature rather than driven by financial interest.”¹³¹

2. WHAT DO WE KNOW ABOUT THE OUTCOMES OF SHAREHOLDER PROPOSALS?

While proposals tend to be effective at getting firms to change their governance arrangements, particularly those that adversely impact the likelihood of a takeover,¹³² studies of the market reaction to proposals provide no evidence that they are widely expected to create economic value.¹³³ In the words of one recent study, “the average shareholder proposal generates zero or negative returns around the meeting date.”¹³⁴ In Canada, the one study to examine this question discovered “significantly negative returns” around shareholder proposals.¹³⁵

The usefulness of these sorts of studies is questionable, however. Nearly all of them are “event” studies that look at the market reaction to the announcement of a shareholder proposal or the news that such a proposal has passed. Virtually all of these studies find no discernable evidence of value creation in these announcements. The problem is that shareholder proposals are frequently announced well before a company sends out its proxy materials and the results of the shareholder vote are usually anticipated before the meeting is held.¹³⁶ The market will, therefore, have priced in the proposal before the dates used

131. *Ibid* at 473.

132. See Re-Jin Guo, Timothy A Kruse & Tom Nohel, “Undoing the Powerful Anti-Takeover Force of Staggered Boards” (2008) 14 J Corp Fin 274; Jie Cai, Jacqueline L Garner & Ralph A Walkling, “Electing Directors” (2009) 64 J Fin 2389; Ali C Akyol & Carolyn A Carroll, “Removing Poison Pills: A Case of Shareholder Activism” (2006) University of Alabama at Tuscaloosa Working Paper [unpublished] [on file with author].

133. See Johnathan M Karpoff, Paul H Malatesta & Ralph A Walkling, “Corporate Governance and Shareholder Initiatives: Empirical Evidence” (1996) 42 J Fin Econ 365; Stuart L Gillan & Laura T Starks, “Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors” (2000) 57 J Fin Econ 275; Jie Cai & Ralph A Walkling, “Shareholders’ Say on Pay: Does it Create Value?” (2011) 46 J Fin & Quantitative Analysis 299; Gantchev & Giannetti 2018, *supra* note 113 at 39-40, table 6; Joao Dos Santos & Chen Song, “Analysis of the Wealth Effects of Shareholder Proposals” (2008), online (pdf): *US Chamber of Commerce* <www.uschamber.com/sites/default/files/legacy/files/analysis_wealth_effects_volume2.pdf> (finding no short-term or long-term improvements in corporate value).

134. Gantchev & Giannetti 2018, *supra* note 113 at 16.

135. Yang, Wang & An, *supra* note 115 at 475-76 (this is the same study, referenced earlier, that found that “shareholder proposals in Canada are not very value-driven” (*ibid* at 461)).

136. See Stuart L Gillan & Laura T Starks, “The Evolution of Shareholder Activism in the United States” (2007) 19 J Applied Corp Fin 55.

by researchers to measure its reaction. As well, both the proxy materials and the announcement of the meeting results contain a great deal of information besides that relating to the proposal, which likely contaminates any price reaction to the proposal.¹³⁷

Attempts to solve these problems by looking only at “close-call” votes, when the market could not reasonably have known whether the proposal would pass,¹³⁸ suffer from significant problems with their internal validity for a variety of reasons. The most significant reason is that the studies of this type, performed thus far, use a dataset that does not measure voting support using the metric outlined in each firm’s corporate charter.¹³⁹ They therefore mis-measure what constitutes a “close-call” vote. Studies looking at “close-call” votes also find themselves considering a tiny fraction of shareholder proposals, which makes it impossible to extract a general conclusion about the economic effects of this form of activism.¹⁴⁰

A final problem with event studies is that, in some cases, the proposal is entangled with other forms of shareholder activism, such as a hedge fund seeking board representation or a raider seeking to open the way to a takeover.¹⁴¹

The problems with event studies (which predominate in the literature) means that it is necessary to focus on the longer-term empirical studies. These either look at the long-run stock performance of the firms targeted by shareholder proposals or examine the actual business performance of the firms, as measured by various accounting metrics. A recent review of the seventeen long-run share price studies on this topic concluded that, “the available evidence is most consistent with the conclusion that shareholder proposals and negotiations are not associated with significant long-run stock returns.”¹⁴² A similar conclusion may be drawn by

137. *Ibid.*

138. See Vicente Cuñat, Mireia Gine & Maria Guadalupe, “The Vote is Cast: The Effect of Corporate Governance on Shareholder Value” (2012) 67 *J of Finance* 1943.

139. See Laurent Bach & Daniel Metzger, “How Close are Shareholder Votes?” (2018) Swedish House of Finance Research Paper No 17-3, online: <www.ssrn.com/abstract=2880523> (noting “scholars in empirical corporate governance have exploited close votes on shareholder proposals in order to identify the impact of governance features, such as poison pills or classified boards” (*ibid* at 27)).

140. See Vicente Cuñat, Mireia Gine & Maria Guadalupe, “Corporate Governance and Value: Evidence From ‘Close Calls’ on Shareholder Governance Proposals” (2013) 25 *J Applied Corporate Finance* 44 at 50 (finding approximately 88 per cent of a large sample of shareholder proposals on governance issues pass or fail by a margin greater than 5 per cent).

141. See Matthew R Denes, Jonathan M Karpoff & Victoria B McWilliams, “Thirty Years of Shareholder Activism: A Survey of Empirical Research” (2017) 44 *J Corp Fin* 405 at 419.

142. *Ibid* at 410.

looking at the shareholder proposal studies that use return on assets, return on equity, and return on sales as the key variables. “Most evidence...indicates that shareholder proposals and direct negotiations are not associated with increases in the target firms’ operating performance.”¹⁴³

There are only a few studies examining non-financial outcomes, but these tend to support the conclusion that shareholder proposals are not particularly valuable. For example, three different studies found that companies targeted by shareholder proposals and direct shareholder negotiation do not change their CEOs at a higher rate.¹⁴⁴

3. WHAT CONCLUSIONS CAN WE DRAW FROM SHAREHOLDER PROPOSALS?

The empirical evidence surrounding shareholder proposals can be easily summarised: They apparently provide no long-run benefits to the corporation, the vast majority appear to be generated for reasons that have little to do with improving the long-run financial performance of the company, and they have no impact on the most obvious target of the good shareholder story—the CEO. There is also evidence that shareholders do not really want their proposals to have an impact. Professors Marcel Kahan and Edward Rock have pointed out that shareholder proposals tend to pursue matters that are minor or irrelevant.¹⁴⁵ For example, shareholders make proposals to redeem existing poison pills, but avoid constraining the board’s ability to adopt a pill in the future, with the result that the proposals “have no impact on a company’s ability to resist a hostile bid.”¹⁴⁶ Shareholders also strongly prefer to use precatory proposals, rather than proposals to amend the bylaws, which would actually be binding on the company.¹⁴⁷

There is very little here to support the good shareholder story and a great deal that seems to support the bad shareholder story.

143. *Ibid* at 411.

144. Diane Del Guercio & Jennifer Hawkins, “The Motivation and Impact of Pension Fund Activism” (1999) 52 J Fin Econ 293; Karpoff, Malatesta & Walkling, *supra* note 133; Michael P Smith, “Shareholder Activism by Institutional Investors: Evidence from CalPERS” (1996) 51 J Fin 227.

145. “Symbolic Corporate Governance Politics” (2014) 94 BUL Rev 1997 [Kahan & Rock, “Symbolic Governance”].

146. *Ibid* at 2001.

147. *Ibid* at 2018-2021 (discussing research that finds “mandatory bylaw amendments of any sort are extraordinarily rare” (*ibid* at 2021)).

B. ACTIVIST SHAREHOLDER CAMPAIGNS

Activist shareholder campaigns are costlier than launching a shareholder proposal, but obviously cheaper than a takeover. They therefore reflect a middle-ground that may be a potentially fertile space for investor influence on corporate governance. Higher costs discourage uninformed activists while still permitting a wide range of institutions to participate.

It is hard to be certain about the scope of shareholder activism. In most years since 2006, there have been over one hundred proxy fights launched by activists in the United States, but these represent only the last resort for an activist whose initial informal approaches have been repudiated by the board.¹⁴⁸ The majority of activist campaigns do not normally get to the proxy fight stage, but rather result in a negotiated resolution.¹⁴⁹ If a proxy fight does occur, activists gain some measure of victory in over two-thirds of them.¹⁵⁰ As a measure of the scope of hedge fund activism, it is telling that, in 2017, *The Wall Street Journal* published, on average, more than one article per day mentioning it.¹⁵¹ Academic commentators tend to believe Canada's legal regime is more favourable to activists than that of the United States.¹⁵²

1. WHAT WE KNOW ABOUT ACTIVISTS AND THEIR TARGETS

Most, but not all, activist investors are hedge funds, and they usually share the same general characteristics as other hedge funds. The managers' compensation

148. See Michal Barzuza & Eric L Talley, "Short-Termism and Long-Termism" (2016) Columbia Law & Economics Working Paper No 526 at 4, online (pdf): <scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=2950&context=faculty_scholarship>.

149. See John C Coffee, "The Agency Cost of Activism: Information Leakage, Thwarted Majorities, and the Public Morality" (2017) European Corporate Governance Institute Law Working Paper No 373/2017, online (pdf): <ecgi.global/sites/default/files/working_papers/documents/finalcoffee.pdf> (noting "[i]n reality, there are relatively few shareholder votes on activists' proposals or director nominees. Instead, the activists and management typically settle their dispute through private negotiations, with the activist sometimes receiving private benefits not available to the other shareholders" (*ibid* at 2)).

150. Barzuza & Talley, *supra* note 148.

151. See Ed deHaan, David Larcker & Charles McClure, "Long-Term Economic Consequences of Hedge Fund Activist Interventions" (2018) European Corporate Governance Institute Finance Working Paper No 577/2018 at 1, online (pdf): <ecgi.global/sites/default/files/working_papers/documents/finaldehaanlarckermcclure.pdf>. See also Frank Partnoy, "US Hedge Fund Activism" in Jennifer G Hill & Randall S Thomas, eds, *Research Handbook on Shareholder Power* (Edward Elgar, 2015) at 99-100.

152. See *e.g.* Hugo Margoc, "Shareholder Activism in Canada: A Deliberate Policy Choice" (2016) 31 BFLR 291.

structures are strongly skewed to short-term payoffs. The most comprehensive attempt to model the economic incentives of hedge fund managers—direct and indirect—found they were strongly sensitive to quarterly performance of the fund and that, for young fund managers in particular, the incentives for making short-term results at the expense of the long term are “particularly large.”¹⁵³ For “the manager of an average-size mutual fund,” a one per cent increase in the return to investors produces “\$1,202,000 in expected future compensation.”¹⁵⁴ In contrast to the typical lock-up in a private equity fund that restricts investors from getting their money back for five to ten years,¹⁵⁵ hedge funds have lock-ups that only range from six months to two years.¹⁵⁶ This means that hedge funds compete for resources on a quarterly basis and that even small improvements in the near term produce enormous (one might say, “extraordinary”) financial benefits for a manager.

As we would expect given these incentives, studies on activist hedge fund investment portfolios find that the median holding period for an investment is 12 months by one measure, and 22 months by another.¹⁵⁷ Another study found that half of activist investments last slightly less than nine months.¹⁵⁸ The short-term horizon of activist investors does not, of course, tell us anything about the quality of their interventions into corporate governance, but it should put us on alert. As Chancellor Leo E. Strine notes, “[i]f out of this debate among those with short-term perspectives comes optimal policy for human investors with far longer time horizons, that happy coincidence would be remarkable.”¹⁵⁹ The simple reality is that activist investors, with a few exceptions, do not bear the risks associated with the long-term results of the strategies they impose on target companies.

153. Jongha Lim, Berk A Sensoy & Michael S Weisbach, “Indirect Incentives of Hedge Fund Managers” (2016) 71 J Fin 871 at 901.

154. *Ibid* at 905.

155. See William W Bratton, “Hedge Funds and Governance Targets” (2007) 95 Geo LJ 1375 at 1384 [Bratton, “Hedge Funds”].

156. *Ibid* at 1383-84. See also John C Coffee & Darius Palia, “The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance” (2016) 41 J Corp L 545 at 573.

157. Coffee & Palia, *ibid* at 567, 572; Brav et al, “Hedge Fund Activism”, *supra* note 33 at 1749.

158. Yvan Allaire & François Dauphin, “Activist Hedge Funds: Creators of Lasting Wealth? What do the Empirical Studies Really Say?” (17 July 2014), online (pdf): *Institut sur la gouvernance* <www.igopp.org/wp-content/uploads/2014/07/IGOPP_Article_Template2014_Activism_EN_v6.pdf> [Allaire & Dauphin, “Creators of Lasting Wealth?”].

159. “Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System” (2017) 126 Yale LJ 1870 at 1876 [Strine, “Who Bleeds When the Wolves Bite?”].

One manifestation of this dynamic is that activist shareholders do not target companies whose businesses they like, but companies which offer the prospect of an intervention that will produce at least a short-term increase in share price. These are usually companies with “low market value relative to book value...with sound operating cash flows and return on assets.”¹⁶⁰ These are not companies that are struggling. Indeed, most studies have found that the targets of activists tend to be more profitable than control samples.¹⁶¹

The nature of the typical activist target is important because the activist playbook is limited. Looking at 1,358 activist engagements between 2000 and 2010, one team of researchers reported that 35.8 per cent resulted in changes to the board (involving the replacement of the CEO, chair, or a non-executive director), 21.5 per cent resulted in changes to pay-out policy (increasing or implementing a share buyback programme, increasing dividend payments), 20 per cent involved a restructuring (spinning off non-core assets or blocking a diversifying acquisition), and the remainder, 22.7 per cent, ended in a takeover of the target firm.¹⁶² Most of these outcomes can broadly be described as examples of financial engineering. With the exception of board changes (which, themselves, are often a precursor to a sale or cash distribution), these outcomes are all ways of delivering increased amounts of corporate cash to the shareholders.

There is little evidence that activist interventions involve questions of business strategy, operational efficiencies, improvements to top-line performance, the development of new products, or calls to increase investments in one aspect or another of the business. Even executive compensation, which commonly appears as a target of activist campaigns, is not usually impacted. As one group of scholars notes, after considering the research on the topic of activists reducing wasteful

160. Brav et al, “Hedge Fund Activism”, *supra* note 33 at 1730; Coffee & Palia, *supra* note 157 at 582.

161. Coffee & Palia, *supra* note 156 at 582. See also April Klein & Emanuel Zur, “Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors” (2009) 64 J Fin 187 at 189; Brav et al, “Hedge Fund Activism”, *supra* note 33 at 1754; Denes, Karpoff & McWilliams, *supra* note 141 (reviewing the literature as a whole and concluding, target firms “tend to have high return on assets” though their equity market performance, below that of peers (*ibid* at 415)); CNV Krishnan, Frank Partnoy & Randall S Thomas, “The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise” (2016) 40 J Corp Fin 296 at 298-99.

162. Yvan Allaire, “The Case For and Against Activist Hedge Funds” (25 May 2015) at 10, online (pdf): *Institut sur la gouvernance* <www.igopp.org/en/the-case-for-and-against-activist-hedge-funds-2>. See also Marco Becht et al, “Returns to Hedge Fund Activism: An International Study” (2017) 30 Rev Fin Stud 2933 at 2953, table 6 [Becht et al, “Returns to Hedge Fund Activism”].

expenditures, “the majority [of the empirical studies] do not report evidence of changes in real variables consistent with this free cash flow hypothesis.”¹⁶³

Even supporters of activist investors admit that hedge funds tend to focus on corporate finance initiatives, as most hedge fund managers do not have much expertise in operational or managerial matters, and they “are not experts in the specific business of [the] target firm.”¹⁶⁴ There is little attempt to remedy these deficiencies. Directors nominated to boards by activists are more than three times more likely to be financial services professionals, compared to the independent directors appointed by firms in the usual course.¹⁶⁵ Studies that have isolated activist campaigns in which the activist succeeds in placing directors on the board find that target companies experience significant underperformance afterwards, unless they are sold.¹⁶⁶

2. WHAT DO WE KNOW ABOUT THE OUTCOMES OF ACTIVIST CAMPAIGNS?

Ultimately what matters is the actual impact of activist investors on target companies. Nearly all research to date suggests that the principal effects of an activist intervention are: a reduction in investment in capital assets and R&D spending; a decline or stagnation in employment levels and wages; a reduction

163. Coffee & Palia, *supra* note 156 at 583.

164. Brav et al, “Hedge Fund Activism”, *supra* note 33 at 1755.

165. See Andrew Borek, Zachary Friesner & Patrick McGurn, “The Impact of Shareholder Activism on Board Refreshment Trends at S&P 1500 Firms” (August 2017), online (pdf): *Institutional Shareholder Services* <www.issgovernance.com/file/publications/Activism-and-Board-Refreshment-Trends-Report-Aug-2017.pdf>.

166. deHaan, Larcker & McClure, *supra* note 151 at 6; Allaire & Dauphin, “Creators of Lasting Wealth?”, *supra* note 158 at 16; Robin Greenwood & Michael Schor, “Investor Activism and Takeovers” (2009) 92 J Fin Econ 362; William Bratton, “Hedge Funds and Governance Targets: Long-Term Results” (University of Pennsylvania Institute for Law and Economics Research Paper No 10-17, 2010), online: <www.ssrn.com/abstract=1677517>; Jonathan Macey & Elaine Buckberg, “Report on Effects of Proposed SEC Rule 14a-11 on Efficiency, Competitiveness and Capital Formation” (17 August 2009), online (pdf): *National Economic Research Associates* <www.nera.com/upload/Buckberg_Macey_Report_FINAL.pdf> (noting that there are “[s]everal...studies [that] establish that when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest” (*ibid* at 12)).

in the amount of cash held by the corporation; and an increase in leverage.¹⁶⁷ The cash freed up from these changes is returned to shareholders in the form of increased dividend payouts or share buybacks.¹⁶⁸

These spending changes amount to basic financial manoeuvres designed to improve return on assets and equity, which in turn drives share price improvements. Earlier studies, in fact, found that return on assets and return on equity did improve for targeted firms.¹⁶⁹ It is clear, however, that these

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167. See Ian D Gow, Sa-Pyung Sean Shin & Suraj Srinivasan, "Activist Directors: Determinants and Consequences" (2014) Harvard Business School Working Paper No 14-120, online (pdf): <www.hbs.edu/faculty/Publication%20Files/14-120_451759fe-d298-4072-81d1-b007fd4d5bc0.pdf>; Heqing Zhu, "The Preventive Effect of Hedge Fund Activism" (2013), online: <www.ssrn.com/abstract=2369533>; Alon Brav, Wei Jiang & Hyunseob Kim, "The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes" (2015) 28 Rev Fin Stud 2723 at 2742 (finding, for example, that plants of targeted firms are more likely to be sold); Alon Brav et al, "Shareholder Power and Corporate Innovation: Evidence from Hedge Fund Activism" (December 2014), online (pdf): *American Economic Association* <www.activistsinsight.com/research/Shareholder%20Power%20and%20Corporate%20Innovation%20Evidence%20from%20Hedge%20Fund%20Activism_150915114423.pdf> (noting that R&D expenditures decline but proxies for innovative activity increase); Coffee & Palia, *supra* note 156 (reviewing the literature and concluding, "activist interventions are 'investment limiting' in that they increase leverage and shareholder payout, while reducing R&D and long-term investment" (*ibid* at 592)). Coffee & Palia also note the evidence in Bebchuk et al showing declines in R&D and long-term investment (*ibid* at 590-91). See Martijn Cremers, Ankur Pareek & Zacharias Sautner, "Short-Term Investors, Long-Term Investments, and Firm Value" (March 2017), online (pdf): *European Corporate Governance Institute* <ecgi.global/sites/default/files/2._short-term_investors_2._long-term_investments_and_firm_value.pdf> [Cremers, Pareek & Sautner, "Long-Term Value"]; Yvan Allaire & François Dauphin, "The Game of 'Activist' Hedge Funds: *Cui Bono?*" (2016) 13 IJDG 279 at 293-94 [Allaire & Dauphin, "Cui Bono?"]. See also Denes, Karpoff & McWilliams, *supra* note 142 at 412 (setting out the results of prior research on capital expenditures, payouts to shareholders, asset divestitures, restructurings, and layoffs).
168. Brav et al, "Hedge Fund Activism", *supra* note 33 at 1771; Denes, Karpoff & McWilliams, *supra* note 142 at 412, table 2 (showing seven studies, six of which found an increase in payout of earnings).
169. Allaire & Dauphin, "Creators of Lasting Wealth?", *supra* note 158 at 16; Alon Brav, Wei Jiang & Hyunseob Kim, "Hedge Fund Activism: A Review" (2010) 4 Foundations & Trends in Fin 185; Nicole M Boyson & Robert M Mooradian, "Corporate Governance and Hedge Fund Activism" (2011) 14 Rev Derivatives Res 169; Christopher P Clifford, "Value Creation or Value Destruction? Hedge Funds as Shareholder Activists" (2008) 14 J Corp Fin 323; Nickolay Gantchev, Oleg R Gredil & Chotibhak Jotikasthira, "Governance Under the Gun: Spillover Effects of Hedge Fund Activism" (2019) 23 Rev Fin 1031; Zhu, *supra* at note 167. See also Greenwood & Schor, *supra* note 166 (finding no change in return of assets for target firms that were not acquired).

improvements were not due to improved business results, but rather the declines in the firms' assets and outstanding shares.¹⁷⁰ It may also be the case that this improvement in metrics is illusory. The only study that has carefully matched targeted firms with control companies showing the same pre-intervention return on assets and financial trends as the targets, found "no evidence of post-activism changes in ROA [return on assets] for target firms."¹⁷¹ It also failed to find any evidence of improvements in return on equity.¹⁷²

Similar results arise from looking at other operational metrics. After reviewing the evidence, Professors Coffee and Palia conclude, "[l]ittle evidence supports the thesis that hedge funds promote growth in sales or asset size."¹⁷³ A little later they note more generally, it is "highly doubtful that operating performance improves as a result of activist interventions."¹⁷⁴ The most recent study on the topic looked at "a more comprehensive set of accounting performance measures including... profit margin, asset turnover, and spread over borrowing costs, but again fail[ed] to find consistent evidence of improvements following activist interventions."¹⁷⁵ This is broadly in line with earlier research that found profitability to be either unaffected or negatively impacted by activist campaigns.¹⁷⁶ Three recent, good quality studies have all found that activism produces no significant improvement in business cash flows.¹⁷⁷

For their part, investment bank analysts apparently do not expect post-activism improvements in corporate earnings, as shown by their earnings forecasts.¹⁷⁸ The market participants with the greatest level of information about target companies simply do not expect to see operational improvements from activist campaigns. It appears they are correct.

If a target company's actual business performance does not improve from activist campaigns, does it at least become more valuable to the shareholders, possibly by improving efficiencies within the firm? In this regard, there are several

170. Clifford, *supra* note 169 at 330-31 (noting "the improvements in operational efficiency are caused by a reduction in firm assets, more so than an improvement in cash flow" (*ibid* at 331)).

171. deHaan, Larcker & McClure, *supra* note 151 at 5.

172. *Ibid*.

173. Bratton, "Hedge Funds", *supra* note 155 at 591.

174. *Ibid* at 592.

175. deHaan, Larcker & McClure, *supra* note 151 at 5-6.

176. Klein & Zur, *supra* note 161 at 223.

177. In the literature, "good quality" studies are ones that carefully match the control group with the targets of activist shareholders. See *e.g. ibid* at 201; Clifford, *supra* note 169 at 330-31; Boyson & Mooradian, *supra* note 169 at 191.

178. deHaan, Larcker & McClure, *supra* note 151 at 6, 26.

difficulties with the empirical literature. Most of the studies focus on the short-term share price impact of 13D announcements by American activist investors that they have crossed the 5 per cent share ownership threshold. There are at least ten studies of this type, which found positive abnormal returns between 3.39 per cent and 6.97 per cent in the month of the announcement.¹⁷⁹ The problem is that stock prices tend to appreciate in response to *all* 13D announcements, not just those filed by activist shareholders. The magnitude of share price appreciation in response to an activist hedge fund 13D filing is not materially different from the market response following 13D filings by insiders, buy-and-hold financial institutions, 10 per cent holders, and others.¹⁸⁰ It appears that investors interpret a 13D filing as evidence that something new is happening with a company; they pile into the stock so they do not miss an opportunity. There is very little basis from these short-term studies to conclude that there is anything special about a corporate governance-inflected activist announcement.

The second problem is that it is difficult to be confident that any change in share price is due to the market anticipating improved corporate governance. As indicated above, hedge fund activists primarily target relatively undervalued firms.¹⁸¹ A 13D announcement can be understood as a signal that a smart investor has found an undervalued asset, rather than as a promise that corporate governance is going to be improved now that an activist has come on the scene.¹⁸² Even longer-term studies of the impact of activist shareholder interventions face the difficulty of disentangling the reasons for the improvement in firm value.¹⁸³

179. Brav et al, "Hedge Fund Activism", *supra* note 33 at 1729-75 (noting an average abnormal monthly return of 5.10 per cent for 1,059 targetings of 882 unique firms, by 236 different hedge fund activists); Klein & Zur, *supra* note 161 (reporting a 5.7 per cent abnormal return during a 36-day period surrounding the filing dates for 134 targeted firms); Christopher P Clifford & Laura Lindsey, "Blockholder Heterogeneity, CEO Compensation, and Firm Performance" (2016) 51 J Fin & Quantitative Analysis 1491; Marco Becht et al, "Returns to Hedge Fund Activism: An International Study" (2017) European Corporate Governance Institute Finance Working Paper No 402/2014, online (pdf): <ecgi.global/sites/default/files/working_papers/documents/ssrn-id23762716_1.pdf> (reporting average abnormal stock returns ranging from 3.93 per cent to 6.97 per cent). See also Becht et al, "Returns to Hedge Fund Activism", *supra* note 162.

180. See Ulf Von Lilienfeld-Toal & Jan Schnitzler, "What is Special about Hedge Fund Activism: Evidence from 13-D Filings" (Swedish House of Finance Research Paper No 14-16, 2014) at 38, online: <www.ssrn.com/abstract=2506704>.

181. Cremers, Pareek & Sautner, "Long-Term Value", *supra* note 167 at 6.

182. *Ibid*; Denes, Karpoff & McWilliams, *supra* note 141 at 408.

183. *Ibid* at 419-20.

Related to this problem is the failure of many studies to use benchmarks or suitable control groups.¹⁸⁴ As the most recent paper on this topic notes, “prior papers that find post-activism improvements in accounting-based operating performance either do not use a benchmark control group, or identify a control group without taking into account pre-activism performance trends.”¹⁸⁵ This is a particular problem given that the targets of hedge fund activists exhibit atypical market performance in the run-up to the intervention (this is, after all, why they are undervalued relative to their peers). Returns to activist campaigns tend to be almost exclusively generated by interventions at smaller firms (including a significant percentage not even listed on a national stock exchange),¹⁸⁶ where mispriced stocks are much more likely.¹⁸⁷ Firms with market values in excess of \$40 million (a remarkably low cut-off for public companies) do not appear to experience any consistent increase in shareholder value from activist shareholder interventions.¹⁸⁸

The short-term nature of much of the empirical research is also unhelpful. With only a couple of exceptions, the studies measure the impact of hedge funds over a period of two years or less.¹⁸⁹ This is strange, given that the actual debate around activist shareholders is couched in terms of whether the financial engineering promoted by them is in the long-term interests of companies. Increasing dividends, share buybacks, and corporate sales are self-evidently in the short-term interests of the current shareholders, but what happens afterwards?¹⁹⁰ A surprisingly small body of research addresses itself to this—the real—debate.¹⁹¹

Probably the best-known paper on the long-term consequences of hedge fund activism is by Professors Lucian Bebchuk, Alon Brav, and Wei Jiang, who looked at companies for a suitably lengthy period of time (five years) and found value-weighted abnormal stock price returns of 5.81 per cent over that period.¹⁹²

184. deHaan, Larcker & McClure, *supra* note 151 at 3.

185. *Ibid.* See e.g. Cremers, Pareek & Sautner, “Long-Term Value”, *supra* note 167 at 7.

186. Allaire & Dauphin, “Cui Bono?”, *supra* note 167 at 286.

187. deHaan, Larcker & McClure, *supra* note 151 at 9.

188. *Ibid.* at 29.

189. See e.g. Allaire & Dauphin, “Creators of Lasting Wealth?”, *supra* note 15 at 158. See also Strine, “Who Bleeds When the Wolves Bite?”, *supra* note 159 at 1955.

190. See John Kay, “The Kay Review of UK Equity Markets and Long-Term Decision Making” (Department for Business, Innovation and Skills, 2012), online (pdf): <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf>.

191. Strine, “Who Bleeds When the Wolves Bite?”, *supra* note 159 at 1966; Denes, Karpoff & McWilliams, *supra* note 142 at 417 (reviewing the then extant research).

192. “The Long-Term Effects of Hedge Fund Activism” (2015) 115 Colum L Rev 1085.

This is the headline result. Unfortunately, by another measure, the study found investors would have received a slightly negative abnormal return over the five years.¹⁹³ There are also serious methodological problems with the study, beginning with the fact it starts with 1,584 companies and ends in year five with only 694 companies, with no attempt to track the companies that are dropped.¹⁹⁴ Several different teams of scholars have written persuasively about several other major flaws in the study.¹⁹⁵ But perhaps most interesting is that, even if we accepted the paper uncritically, when the returns on assets experienced by the target companies are compared with the returns experienced by (inadequately) industry-matched control companies, “the positive impact of hedge funds, if that difference were really attributable to their intervention, would amount to going from a performance infinitesimally smaller than industry performance to a performance infinitesimally better than industry performance.”¹⁹⁶

Using the same dataset as Bebchuk, Brav, and Jiang, but more carefully matching control firms with the targets of hedge fund activism, a recent paper found that “the firm value of the target firms tends to be 5.5% lower than the firm value of [the] control firms at the end of the fiscal year in which the activist hedge funds start their campaign, and about 9.8% lower...three years thereafter.”¹⁹⁷ The researchers note that this result is robust across several matching protocols and adding different fixed effects.¹⁹⁸

This then raises the question: How do the activist hedge funds generate their returns if corporate performance declines? Of course, some of it may be related to timing the sale of their shares, extracting control premiums from companies, and using leverage.¹⁹⁹ Given that the returns tend to be concentrated in the smallest target companies, some of the returns may be generated by identifying undervalued companies and bringing them to the attention of the market as a whole. However, the evidence mostly suggests that the vast majority of the returns generated from hedge fund activism arise from those cases where the activist

193. *Ibid* at 1126-27.

194. Allaire & Dauphin, “Creators of Lasting Wealth?”, *supra* note 158 at 9.

195. Coffee & Palia, *supra* note 157 at 587; Allaire & Dauphin, “Creators of Lasting Wealth?”, *supra* note 158 at 9; deHaan, Larcker & McClure, *supra* note 151.

196. Allaire & Dauphin, “Creators of Lasting Wealth?”, *supra* note 158 at 9.

197. KJ Martijn Cremers et al, “Hedge Fund Activism and Long-Term Firm Value” (January 2016) University of Notre Dame Working Paper at 4-5, online (pdf): <ccl.yale.edu/sites/default/files/files/leo16_Sepe.pdf>.

198. *Ibid* at 5. See also Allaire & Dauphin, “Cui Bono?”, *supra* note 167 at 297 (finding no impact on performance after three years).

199. *Ibid* at 296.

intervention results in a sale of the company. As a recent study put it, “nearly all the positive long-term returns to activist interventions are concentrated in firms that are subsequently acquired.”²⁰⁰ Activist campaigns are followed by a significantly increased frequency of target firm acquisition,²⁰¹ and a large body of research suggests this phenomenon is the primary driver of hedge fund returns.²⁰²

3. WHAT CONCLUSIONS CAN WE DRAW FROM HEDGE FUND ACTIVISM?

There is very little support in the data we have reviewed for the good shareholder story. While activists replace CEOs at statistically significant rates,²⁰³ there is little evidence that the companies targeted by activists differ from their peers in the way managers were using free cash flows prior to the activists arriving on the scene,²⁰⁴ and no evidence that the returns generated by activist investors are connected with reducing these agency costs.²⁰⁵

The data contains considerable evidence for the bad shareholder story, however. Activist interventions are short-term, they bear little evidence the activist firm understands the business of the target, they typically involve fairly routine financial engineering steps to boost share value while not improving the business and profits of the company, and while interventions increase share price in the short-term, it is unlikely that this is due to market anticipation of improved corporate governance. Where the activist succeeds in placing nominees on the board, the companies significantly underperform their peers. Finally, the evidence suggests that the surviving targets do worse in the long-term than carefully matched control firms.

200. deHaan, Larcker & McClure, *supra* note 151 at 6.

201. See Nicole M Boyson, Nickolay Gantchev & Anil Shivdasani, “Activism Mergers” (2017) 126 J Fin Econ 54.

202. deHaan, Larcker & McClure, *supra* note 151; Greenwood & Schor, *supra* note 166; Allaire & Dauphin, “Cui Bono?”, *supra* note 167 at 296; Brav et al, “Hedge Fund Activism”, *supra* note 33 at 1759; Coffee & Palia, *supra* note 156 (noting “changes in the expected takeover premium, more than operating improvements, account for most of the stock price gain, both in short-term and long-term studies” (*ibid* at 588)).

203. See “Lazard’s Shareholder Advisory Group: Review of Shareholder Activism — 3Q 2017” (2017) at 2, online (pdf): <www.lazard.com/media/450309/lazard-review-of-shareholder-activism-q3-2017-final.pdf> (finding that annualised CEO turnover increases from 12 per cent to 23 per cent for activist targets); Allaire & Dauphin, “Cui Bono?”, *supra* note 1 (showing “a large difference” in the rate of CEO turnover between activist targets and the control firms (*ibid* at 289)); Zhu, *supra* note 167 at 15-17.

204. Coffee & Palia, *supra* note 156 at 582-83 (reviewing the literature).

205. *Ibid* at 589.

C. TAKEOVERS

Of all the forms of shareholder activism, a takeover offer is the most costly. The offeror bears the entire burden of the intervention and its long-term consequences. The market for corporate control therefore provides the strongest potential case for the good shareholder story as, on its face, it appears to consist of a shareholder finding value in constraining managerial agency costs by taking control of the company.²⁰⁶

The merits of takeovers for the target company's shareholders seem obvious: Acquisitions must always be conducted at a premium to the market. Nevertheless, some scholars express concern about two possible problems. First, there is the risk that value-decreasing takeovers are possible in circumstances where shareholder misinformation occurs.²⁰⁷ This might be the case, for example, with companies characterised by non-linear innovation, as the companies' current performance may not be indicative of their future performance. Some long-term investments will depress current earnings and the market price may not accurately reflect future cash flows.²⁰⁸ Shareholders may also mistake the value of businesses that experience significant earnings volatility, or whose market price is impacted by macro-economic or industry factors that do not reflect the companies' fundamentals.²⁰⁹ Companies can be "caught" in a general market or industry sell-off. As two academics noted about the frequently misunderstood Efficient Capital Markets Hypothesis, it "does not imply that the share price equals the pro rata value of the discounted free cash flows of the corporation....To say that no investment strategy can outperform the market does not...say anything about the stock price's accuracy in measuring the corporation's fundamental value."²¹⁰

206. See *e.g.* Anita Anand, Fraser Harland & Laurent Lacas, "The Future of Poison Pills in Canada: Are Takeover Bid Reforms Needed?" (2015) 61 McGill LJ 1.

207. See Jean-Jacques Laffont & Jean Tirole, "Repeated Auctions of Incentive Contracts, Investment, and Bidding Parity with an Application to Takeovers" (1988) 19 RAND J Econ 516.

208. See Lynn A Stout, "The Mechanisms of Market Inefficiency: An Introduction to the New Finance" (2003) 28 J Corp L 635 (summarizing the evidence that short-term share prices deviate from their fundamental values for extended periods of time); LeRoy, *supra* note 43 (citing evidence of regularly occurring discrepancies between price and fundamental value); Louis Lowenstein, "Searching for Rational Investors in a Perfect Storm: A Behavioural Perspective" (2006) 7 J Behav Fin 66.

209. See Michael L Wachter, "Takeover Defense When Financial Markets are (Only) Relatively Efficient" (2003) 151 U Pa L Rev 787.

210. Bratton & Wachter, "Shareholder Empowerment", *supra* note 43 at 692.

The second problem relates to what is referred to as “the bonding hypothesis.” This is a theory that “takeover defenses increase the value of managers’ commitments to maintain their promised operating strategy and not to opportunistically exploit their counterparties’ investments in the...firm.”²¹¹ The firm’s counterparties—customers, lenders, employees, and suppliers—are encouraged to invest in the business, increasing its value. However, the increase in value comes expressly from the assurance that these investments cannot be expropriated by the shareholders through a takeover. So, for example, the authors of one study found that takeover defenses are deployed by Initial Public Offering (IPO) firms precisely when they have large customers, dependent suppliers, or strategic partners.²¹² The study found that these relationships last longer for firms with takeover defenses and these firms appear to get a higher price at the time of going public than firms without the defenses.

1. WHAT WE KNOW ABOUT TAKEOVERS

Takeovers are very good for the shareholders of the target company. Between 1973 and 2002, the average acquisition premium was about 50 per cent in the United States and 23 per cent in Canada.²¹³ Takeovers are not, however, particularly good for the shareholders of the acquiring company.²¹⁴ A 2008 study found that the shares of the bidder experience no bump in price at the time the tender offer is announced; the returns on those shares are indistinguishable from those of the general market.²¹⁵ Hostile bids result in worse acquirer stock performance

211. William C Johnson, Jonathan M Karpoff & Sangho Yi, “The Bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms” (2015) 117 J Fin Econ 307 at 329.

212. *Ibid.*

213. See B Espen Eckbo, “Bidding Strategies and Takeover Premiums: A Review” (2009) 15 J Corp Fin 149. See also Gregor Andrade, Mark Mitchell & Erik Strafford, “New Evidence and Perspectives on Mergers” (2001) 15 J Econ Persp 103; Gregg A Jarrell, James A Bickley & Jeffrey M Netter “The Market for Corporate Control: The Empirical Evidence Since 1980” (1988) 2 J Econ Persp 49; Michael C Jensen & Richard S Ruback, “The Market for Corporate Control: The Scientific Evidence” (1983) 11 J Fin Econ 5; Tingle, “Fiduciary Duty”, *supra* note 61 at 308.

214. See Bernard S Black, “Bidder Overpayment in Takeovers” (1989) 41 Stan L Rev 597.

215. Marina Martynova & Luc Renneboog, “A Century of Corporate Takeovers: What Have We Learned and Where Do We Stand?” (2008) 32 J Banking & Fin 2148. See also B Espen Eckbo & Karin S Thorburn, “Gains to Bidder Firms Revisited: Domestic and Foreign Acquisitions in Canada” (2000) 35 J Fin & Quantitative Analysis 1 (finding, interestingly, that in the period of 1964 to 1983 domestic acquirors generated positive returns and US bidders generated negative returns when either group announced the takeover of a Canadian company); Walid Ben-Amar & Paul André, “Separation of Ownership from Control and Acquiring Firm Performance: The Case of Family Ownership in Canada” (2006) 33 J Bus Fin & Acct 517 (also finding positive announcement returns in Canada, particularly when the bidder has a controlling shareholder).

than friendly deals.²¹⁶ Possibly connected to this, hostile bids tend to present target company shareholders with a higher premium, doubtless, in part, because shareholders require an extra inducement to sell against the recommendation of the directors.²¹⁷

Longer term studies on the economics of mergers and acquisitions (M&A) transactions are decidedly negative for acquirers. For example, studies that measure operating performance over time (such as earnings or other measures of cash flows) largely find that acquirers tend to underperform their peers for the next several years.²¹⁸ Casting considerable doubt on one of the commonly-given reasons for an acquisition—that there are synergies between the two companies that will lead to lower costs and higher profits—it appears that acquisitions of firms in the same industry as the bidder produce no performance advantage over acquisitions in an unrelated industry.²¹⁹

Surveying the evidence, one team of authors observed, “[c]onsensus seems to have formed that the value of deals generally flows to shareholders of the target firm....[E]xperience shows that the surviving firm often fails to realise economic value.”²²⁰ Where does the value received by target company shareholders come from? At least some of it appears to come from the expropriation of value from other corporate constituencies. For example, it can arise from increased leverage applied to the target business, either from the addition of more debt, the sale of assets, or both. An American study looking at the impact of state takeover laws on corporate debt found that bonds in takeover-friendly states had significantly higher yields at the time of issue, and that issuers had higher total levels of leverage.²²¹ Critics of takeovers argue that the premium received by target company shareholders also comes from redeploying target company cash from long-term projects, cutting capital expenditures, and reducing labour

216. See Marc Goergen & Luc Renneboog, “Shareholder Wealth Effects of European Domestic and Cross-border Takeover Bids” (2004) 10 *Eur Fin Mgmt* 9.

217. Johnson, Karpoff & Yi, *supra* note 211; Henri Servaes, “Tobin’s Q and the Gains from Takeovers” (1991) 46 *J Fin* 409.

218. Martynova & Renneboog, *supra* note 216 at 2168.

219. *Ibid* at 2159.

220. David Larcker & Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences*, 2nd ed (Pearson Press, 2015) at 322.

221. Bill B Francis et al, “The Effect of State Antitakeover Laws on the Firm’s Bondholders” (2010) 96 *J Fin Econ* 127.

costs.²²² These are more contentious claims and sorting out the truth of them is not important for our purposes.

The question we are interested in is: How much of the takeover premium is the result of reducing agency costs? This is the story commonly told about takeovers,²²³ and it would provide powerful support for the good shareholder story. The empirical literature suggests several problems with an uncritical acceptance of it. First, after studying over two thousand corporations that were the targets of takeovers, Anup Agrawal and Jeffrey Jaffe concluded, “[o]verall, we do not find much support for the inefficient management hypothesis. Target firms as a group do not underperform over a decade-long pre-bid period, whether performance is measured by operating returns or stock returns.”²²⁴ The one study to consider this question specifically in Canada also found that their results “contradict the general wisdom that the market for corporate control penalises underperforming companies.”²²⁵ Takeovers are not, apparently, a response to managerial misbehaviour.

Indeed, the usual formula, that takeovers discipline managers, may be precisely backwards. Most senior executives have golden parachutes or severance clauses that produce major payouts on termination after a change of control.²²⁶ They have options and shares, which market norms prevent them from selling while they are employed by the company.²²⁷ The takeover premium will produce significant wealth for them in their capacity of equity holders as well. Possibly the most conclusive evidence that the agency cost explanation for takeovers is incorrect is the impact of a takeover on executives’ reputation. Far from being

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222. See *e.g.* Lynn A Stout, “Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right” (2005) 60 Bus Law 1435 at 1441; Ling Cen, Sudipto Dasgupta & Rik Sen, “Discipline or Disruption? Stakeholder Relationships and the Effect of Takeover Threat” (2016) 62 Mgmt Science 2820 (finding a positive effect of US business combination statutes on the performance of firms with important principal customers. These firms respond to the imposition of the statutes by reducing their selling, general, and administrative expenses as a proportion of sales, suggesting takeovers are expected to result in the expropriation of value from customers).
223. See Henry G Manne, “Mergers and the Market for Corporate Control” (1965) 73 J Pol Econ 110 at 117.
224. “Do Takeover Targets Underperform? Evidence from Operating and Stock Returns” (2003) 38 J Fin & Quantitative Analysis 721 at 722.
225. Stefan Luthringshauser & Julinda Nuri, “The Mystery of the Market for Corporate Control: Takeover Likelihood of Underperforming Firms” (2012) at 15, online: <www.ssrn.com/abstract=2126509>.
226. See Jeffrey Marshall, “Looking Hard at Executive Pay” (2006) 22 Fin Executive 36.
227. See Brian J Hall & Kevin J Murphy, “The Trouble with Stock Options” (2003) 17 J Econ Persp 49.

generally stigmatised as untrustworthy agents, displaced managers trumpet the fact they successfully sold the company at a significant premium for the shareholders. The vast majority of takeovers, after all, are not hostile, but friendly.²²⁸ If we are looking for excessive agency costs in takeovers, they may be at least as likely manifested by managers selling the company for personal gain as by managers clinging to power to retain their perquisites.

Finally, while there are a few good, modern studies about companies that survive as independent firms following an unsolicited takeover offer, anecdotal evidence suggests that many go on to outperform their peers.²²⁹ The one study looking at long-term outcomes of successful takeover defenses found that the companies outperform their peers by 40 per cent over the five years following a successful defense, but only if the target companies increase their leverage.²³⁰

2. WHAT DO WE KNOW ABOUT THE USE OF TAKEOVER DEFENSES?

Most of the research surrounding the market for corporate control has revolved around the use and effects of various takeover defenses. From 1980 to 2011, almost two thousand articles on antitakeover provisions appeared in peer-reviewed academic journals.²³¹ Unfortunately, much of this research is deeply flawed.

Some of the problems are of the garden-variety statistical nature, such as reverse causality.²³² By far the biggest problem arises, however, from widely held misunderstandings about corporate law in the United States (where nearly all the research is conducted). A vast amount of the research on takeover defenses

228. See Bebchuk, Coates & Subramanian, *supra* note 79 (noting that only 1 per cent of public companies receive a hostile bid and most of these remain independent or are acquired by a friendly bidder).

229. Yvan Allaire & François Dauphin, “The Value of ‘Just Say No’: A Response to ISS” (November 2014), online (pdf): *Institut sur la gouvernance* <www.igopp.org/wp-content/uploads/2015/02/IGOPP_Article_Template2014_ValueJustSayNo_EN_v61.pdf> (examining four companies: NRG Energy, AirGas, Casey’s, and Illumina); Sabastian V Niles, “Shareholder Returns of Hostile Takeover Targets” (24 October 2014), online (blog): *Harvard Law School Forum on Corporate Governance* <corpgov.law.harvard.edu/2014/10/24/shareholder-returns-of-hostile-takeover-targets> (looking at Terra Industries); Martin Lipton, “Just Say No” (9 December 2014), online (blog): *Harvard Law School Forum on Corporate Governanc* <www.corpgov.law.harvard.edu/2014/12/09/just-say-no> (looking at McGraw-Hill).

230. See Assem Safieddine & Sheridan Titman, “Leverage and Corporate Performance: Evidence from Unsuccessful Takeovers” (1999) 54 J Fin 547.

231. See Miroslava Straska & H Gregory Waller, “Antitakeover Provisions and Shareholder Wealth: A Survey of the Literature” (2014) 49 J Fin & Quantitative Analysis 933.

232. See Emiliano M Catan, “The Insignificance of Clear-Day Poison Pills” (2018) 48 J Leg Stud 1.

focuses on the poison pill, which, in the United States, acts as a complete bar to a takeover so as long as the board keeps it in place.²³³ This research examines questions such as changes in firm value or business outcomes following the adoption or termination of a poison pill.²³⁴ It also looks at the relationship a pill has on long-term firm performance, executive compensation, CEO turnover, and other features of corporate governance.²³⁵ Unfortunately, the presence or absence of a pill at any given time does not betray anything about the company, as boards can introduce a pill at any time, even in the face of a hostile bid, without seeking shareholder approval.²³⁶ Corporate directors and their lawyers are very aware of this fact, and so the presence or absence of a pill in a company is not indicative of how it will react to a takeover, whether the directors feel vulnerable to a hostile bid, whether management has too much influence over the board, whether the board holds shareholders in esteem or contempt, or whether the company is well-governed or abused.²³⁷ It tells you nothing, in short, about the company or the degree of its exposure to the market for corporate control.²³⁸

This point about poison pills has been made repeatedly by several law professors since the turn of the century.²³⁹ The failure of these warnings to impact the work of other members of the legal academy and finance scholars is

233. See Emiliano M Catan & Marcel Kahan, “The Law and Finance of Antitakeover Statutes” (2016) 68 *Stan L Rev* 629 at 637.

234. See Brent W Ambrose & William L Megginson, “The Role of Asset Structure, Ownership Structure, and Takeover Defenses in Determining Acquisition Likelihood” (1992) 27 *J Fin & Quantitative Analysis* 575 (looking at the impact of a pill on the likelihood of a firm being acquired); Robert Comment & G William Schwert, “Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures” (1995) 39 *J Fin Econ* 3 (examining whether pills deter bids).

235. See James A Brickley, Jeffrey L Coles & Rory L Terry, “Outside Directors and the Adoption of Poison Pills” (1994) 35 *J Fin Econ* 371; Paul H Malatesta & Ralph A Walkling, “Poison Pill Securities: Stockholder Wealth, Profitability, and Ownership Structure” (1988) 20 *J Fin Econ* 347.

236. John C Coates, “Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence” (2000) 79 *Tex L Rev* 271 at 286-87.

237. *Ibid* at 297-304 (discussing how, even merely viewed as a signal, the adoption of a poison pill tells nothing about the company or its expected future).

238. See also Bebchuk, Coates & Subramanian, *supra* note 79 (one study found, for example, that every company targeted by a hostile bid brought in a pill either in advance or after the bid was made).

239. Coates, *supra* note 238 at 297-304; Klausner, “Fact and Fiction”, *supra* note 66 at 1325-67; Michael Klausner, “Empirical Studies of Corporate Law and Governance: Some Steps Forward and Some Steps Not” (2018) European Corporate Governance Institute Law Working Paper No 381/2018, online (pdf): <ecgi.global/sites/default/files/working_papers/documents/finalklausner.pdf> [Klausner, “Some Steps Forward”].

surprising. For example, the very influential scheme for rating “good governance” proposed by Paul Gompers, Joy Ishii, and Andrew Metrick (the “G-Index”), or the revised scheme proposed by Lucian Bebchuk, Alma Cohen, and Allen Ferrell (the “E-Index”), both include the presence or absence of a poison pill as an important part of their metrics.²⁴⁰

Similar problems are created by the mistaken assumption that other takeover defenses are effective. Business combination statutes, fair price statutes or charter provisions, control share acquisition statutes, and cash-out statutes all have no impact on a firm’s exposure to a hostile takeover.²⁴¹ Nevertheless, all of them are present as part of the G-Index.²⁴² Other defenses examined in the literature, such as measures making it difficult or impossible for shareholders to call meetings, or restrictions on shareholder voting, do not have any impact on companies with a staggered board.²⁴³ While staggered boards are rare now, they were relatively common when much of the research on takeover defenses was conducted.²⁴⁴ Provisions requiring supermajority shareholder votes to amend corporate charters or approve a merger also do not impact the outcome of hostile bids, as any charter amendment must also be approved by the board, and a merger vote would only occur if the hostile bidder had been materially successful in his bid.²⁴⁵ Golden parachutes, which are often assumed by researchers to inhibit takeovers, in fact likely encourage them.²⁴⁶ This means, for example, that five of the six elements tracked by the E-Index are not useful measures of entrenchment or governance

240. See Paul Gompers, Joy Ishii & Andrew Metrick “Corporate governance and equity prices” (2003) 118 QJ Econ 107; “Corporate Governance and Equity Prices” (2003) 118 QJ Econ 107; “What Matters in Corporate Governance?” (2009) 22 Rev Fin Stud 783; Tingle, “Can We Measure It?”, *supra* note 9 (a comprehensive review of the empirical evidence on the validity of these indices).

241. Klausner, “Fact and Fiction”, *supra* note 66 at 1365; Catan & Kahan, *supra* note 233 (noting that “[c]orporate lawyers and academics generally dismiss these antitakeover statutes as irrelevant” (*ibid* at 632)).

242. See Gompers, Ishii & Metrick, *supra* note 240. See also Johnson, Karpoff & Yi, *supra* note 211 at 312 (in which other problems with the G-Index are discussed).

243. Klausner, “Some Steps Forward”, *supra* note 241 at 19, 31-33.

244. See David F Larcker, Gaizka Ormazabal & Daniel J Taylor, “The Market Reaction to Corporate Governance Regulation” (2011) 101 J Fin Econ 431.

245. See also Coates, *supra* note 236 at 320-23.

246. See Richard A Lambert & David F Larcker, “Golden Parachutes, Executive Decision-Making and Shareholder Wealth” (1985) 7 J Acct Econ 179.

quality.²⁴⁷ Since being published in 2009, over one thousand studies²⁴⁸ have mistakenly used the E-index on the assumption that it offers something useful about corporate boards and managers.²⁴⁹

What, in the takeover defense literature, can be used to evaluate the two shareholder stories? The largest relevant body of research concerns staggered boards. Because poison pills form a complete barrier to a hostile takeover, the bidder must always gain control of the target board of directors to remove the pill. This takes two years for a US-incorporated firm with a staggered board. As a judge of the Delaware Court of Chancery observed in a recent case, “no bidder to my knowledge has ever successfully stuck around for two years and waged two successful proxy contests to gain control of a classified board in order to remove a pill.”²⁵⁰ It is the presence of a staggered board, therefore, not the presence of a poison pill, that says something meaningful about a company’s exposure to the market for corporate control.

In relation to staggered boards, we see the same pattern in the research that we observed in relation to shareholder activism. Nearly all of the initial research found that staggered boards were associated with lower firm value,²⁵¹ and that introducing staggered boards was associated with negative abnormal returns.²⁵² These studies recognised that there could be problems with causality; since most governance arrangements are adopted in response to firm-specific circumstances, staggered boards could be produced by low firm values rather than (as was generally assumed) the other way around.

The early studies on staggered boards had another problem: They used a relatively limited time period (1995 to 2002), during which there were very

247. Klausner, “Some Steps Forward”, *supra* note 241 at 30.

248. See The President and Fellows of Harvard College, “Links to 1002 Studies that Use the Entrenchment Index (Bebchuk, Cohen, and Ferrell, 2009)” (October 2020), online: <www.law.harvard.edu/faculty/bebchuk/studies.shtml>; Tingle, “Can We Measure It?”, *supra* note 9 at 223-61.

249. Tingle, “Can We Measure It?”, *supra* note 9 at 248; Klausner, “Fact and Fiction”, *supra* note 66 at 1363-69.

250. *Air Products and Chemicals Inc v Airgas Inc*, 16 A.3d 48 at 113 (Del Ch, 2011).

251. See Lucian A Bebchuk & Alma Cohen, “The Costs of Entrenched Boards” (2005) 83 J Fin Econ 501; Olubunmi Faleye, “Classified Boards, Firm Value, and Managerial Entrenchment” (2007) 83 J Fin Econ 501; Bebchuk, Coates & Subramanian, *supra* note 79; Alma Cohen & Charles CY Wang, “How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment” (2013) 110 J Fin Econ 627.

252. See James M Mahoney & Joseph T Mahoney, “An Empirical Investigation of the Effect of Corporate Charter Antitakeover Amendments on Stockholder Wealth” (1993) 14 Strategic Mgmt J 17; Bebchuk, Coates & Subramanian, *supra* note 79; Ronald W Masulis, Cong Wei & Fei Xie, “Corporate Governance and Acquirer Returns” (2007) 62 J Fin 1851.

few companies either adopting a staggered board or removing one.²⁵³ In recent years, much larger studies have been performed, capturing the wave of staggered boards that arose in the 1980s and the opposite move to de-stagger boards in the years following 2005.²⁵⁴ These studies also began looking at differences in firm value over several decades, as governance arrangements evolve, rather than simply comparing value across firms with different governance arrangements at a single point in time.²⁵⁵

These later, better studies find that the results of the earlier studies were the result of reverse causality. “[F]irms with lower value are substantially more likely to adopt a staggered board.”²⁵⁶ They also found that, when the much larger data set of firms is examined, staggered boards are either positively associated with an increase in firm value²⁵⁷ or that they produce no material change in firm value.²⁵⁸

253. See KJ Martijn Cremers, Lubomir Litov & Simone M Sepe, “Staggered Boards and Firm Value, Revisited” (2017) 126 J Fin Econ 422 at 425 [Cremers, Litov & Sepe, “Staggered Boards”].

254. *Ibid.* See also KJ Martijn Cremers & Simone M Sepe, “The Shareholder Value of Empowered Boards” (2016) 68 Stan L Rev 67 [Cremers & Sepe, “Empowered Boards”].

255. There are also problems in some of the earlier research arising from the incorporation of penny stocks traded over the counter or sample sizes that are too small. For a representative discussion, see Yakov Amihud, Markus Schmid & Steven Solomon, “Do Staggered Boards Affect Firm Value?” (2018) 30 J Applied Corp Fin 61 at 74.

256. *Ibid* at 5; Cremers, Litov & Sepe, “Staggered Boards”, *supra* note 254 at 423.

257. Cremers, Litov & Sepe, “Staggered Boards”, *supra* note 254 at 431, 441 (finding that between 1978 and 2015, staggering up (or down) in a given year is associated with an increase (or decrease) in Tobin’s Q of approximately 3 per cent in the same fiscal year, of 4.2 per cent over the next year, and a cumulative increase of 7.4 per cent over the next four fiscal years); Cremers & Sepe, “Empowered Boards”, *supra* note 254 at 103–04 (between 1978 and 2011, although firms with staggered boards are 2.6 per cent lower than average, when industry-fixed effects are replaced by firm-fixed effects, “staggered boards have an average overall impact on firm value—resulting from combining the changes...experienced by firms that stagger up and by firms that stagger down—that is positive and equal to 3.7%” (*ibid* at 103)). Two of the most prominent authors of the earlier research defended this. See Lucian A Bebchuk & Alma Cohen, “Recent Board Declassifications: A Response to Cremers and Sepe” (2017), online: <www.ssrn.com/abstract=2970629> (Cremers et al, in more recent studies, responded convincingly—to this author, at least). See KJ Martijn Cremers & Simone M Sepe, “Board Declassification Activism: Why Run Away from the Evidence?” (2017), online: <www.ssrn.com/abstract=2991854> (noting “[t]his reply responds to the Bebchuk-Cohen critique. Our analysis demonstrates that their critique remains essentially silent on the main result [of Cremers and Sepe’s research], namely that firm values on average significantly declined after...declassifications” (*ibid* at 3)) [Cremers & Sepe, “Board Declassification Activism”].

258. Amihud, *supra* note 255; NewsRx, “New Law Reviews Study Findings Recently Were Reported by Y. Amihud and Co-Researchers (Settling the Staggered Board Debate)” *Politics & Government Business* (7 March 2019) 98 (noting “[t]he effect of a staggered board is idiosyncratic; for some firms it increases value, while for other firms it is value-destroying” (*ibid*)).

More interestingly, later studies found that while staggered boards apparently discourage hostile bids, when a hostile takeover is launched, the staggered board does not appear to affect the company's value relative to bid targets without a staggered board.²⁵⁹ It is hard to see how this is compatible with the usual managerial entrenchment narrative surrounding takeover defenses. "These results are not consistent with the notion that classification, on average, facilitates self-dealing by incumbent managers at the expense of target shareholders."²⁶⁰

A possibly more helpful thread in the scholarly literature looks at board classification in several exogenous natural experiments in an attempt to disentangle the wealth effects of staggered boards from omitted variables, and to reduce the risk of getting the direction of causality wrong. In this vein, the Harvard Shareholder Rights Project, which targeted companies for declassification between 2011 and 2014, without regard to other characteristics of the companies and without advanced notice to the market, has been found to have caused "economically and statistically significant reductions in firm value...both in absolute terms and relative to declassifications occurring [at other firms]."²⁶¹ These wealth effects appear to have arisen largely from affected firms with high R&D expenditures.²⁶²

Similarly, a law passed in Massachusetts, which imposed a staggered board on all firms incorporated in that state, produced significant and positive average increases in Tobin's Q.²⁶³ Another study looked at the impact of various recent legislative and regulatory events in the United States potentially impacting staggered boards, finding that the market reaction in every case suggests staggered boards are value-enhancing.²⁶⁴ Finally, "dead hand pills" serve as a kind of proxy for staggered boards, since they are a poison pill that can only be removed by the

259. See Thomas W Bates, David Becher & Michael Lemmon, "Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control" (2008) 87 J Fin Econ 656.

260. *Ibid* at 669.

261. Cremers & Sepe, "Board Declassification Activism", *supra* note 257 at 2. See also KJ Martijn Cremers & Simone M Sepe, "Board Declassification Activism: The Financial Value of the Shareholder Rights Project" (2017), online: <www.ssrn.com/abstract=2962162>.

262. *Ibid* at 5-6.

263. See Robert Daines, Shelley Xin Li & Charles CY Wang, "Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment" (2018) Harvard Business School Working Paper No 16-105, online (pdf): <www.hbs.edu/faculty/Publication%20Files/16-105_554d24a7-64bf-4f71-9b51-4d3391971106.pdf>.

264. See Larcker, Ormazabal & Taylor, *supra* note 244.

same “continuing” directors that imposed it. The research finds that dead hand pills are associated with wealth gains to shareholders.²⁶⁵

Some studies have looked at the impact of staggered boards on things other than shareholder wealth. Several of these are relevant to evaluating the two shareholder stories. One study found that a staggered board was just as likely to terminate a CEO as a board elected annually.²⁶⁶ Another study found that the presence of a staggered board had no impact on the amounts paid to executives or the pay structures used by the firm.²⁶⁷ A study of American banks found that classified boards were roughly 18 to 26 per cent less likely to require state bailouts in the wake of the 2008 financial crisis.²⁶⁸

3. WHAT CONCLUSIONS CAN WE DRAW FROM TAKEOVERS?

Once again, the empirical research around the market for corporate control provides little support for the good shareholder story. There does not appear to be managerial underperformance in the decade preceding a takeover bid. Targets surviving as independent entities following a failed bid tend to outperform the market (notwithstanding management and boards remaining intact), and at least some—possibly all—of the gains to target company shareholders associated with a takeover are the result of the same kind of financial engineering we saw in activist campaigns. There is little evidence, in any event, that the premium paid on successful bids is generated by operating improvements under new management.

In contrast, there is a great deal of support for the bad shareholder story in the empirical literature. The one effective takeover defense in the United States, the staggered board, is associated with better firm performance and higher shareholder value (or no change to shareholder value), and immunity from the market for corporate control seems to have no effect on CEO turnover or executive pay. To the extent that there is variation among companies, there

265. See Katharine Gleason & Mark Klock, “Is There Power Behind the Dead Hand? An Empirical Investigation of Dead Hand Poison Pills” (2008) 7 Corp Ownership & Control 370. For a summary of dead hand poison pills under Delaware law, see Peter Letsou, “Are Dead Hand (And No Hand) Poison Pills Really Dead?” (2000) 68 U Cin L Rev 1101.

266. Cremers, Litov & Sepe, “Staggered Boards”, *supra* note 253 at 443.

267. See KJ Martijn Cremers, Saura Masconale & Simone M Sepe, “CEO Pay Redux” (2017) 96 Tex L Rev 205.

268. See Daniel Ferreira et al, “Shareholder Empowerment and Bank Bailouts” (2013) London School of Economics Working Paper No 345/2013, online (pdf): <eprints.lse.ac.uk/56083/1/_lse.ac.uk_storage_LIBRARY_Secondary_libfile_shared_repository_Content_Kershaw%2C%20D_Shareholder%20empowerment_Kershaw_Shareholder%20empowerment_2014.pdf>.

is evidence that companies pursuing long-term strategies (measured by R&D expenditures) and needing non-financial investments from strategic partners, suppliers, or customers, disproportionately benefit from protections against shareholder power.

IV. CONCLUSION

It is understandable that market participants, including regulators, have spent most of the past several decades convinced of the merits of the good shareholder story. It is the dominant narrative in most academic discussions of corporate law and finance, and most of the early research on shareholder interventions suggested they were value-creating. It has only been in the last decade or so that the limitations on that early research have been well-understood: the problems with event studies; the importance of carefully matching control firms; the mistakes in what actually serves as a takeover defense; and the limitations of studies that look at only a few years of data. It is noteworthy that most of the longer-term, multi-decade studies have been published only recently.

There is still a great deal of controversy in the literature, of course. The simple fact is that all studies of corporate governance have difficulty establishing the direction of causality or accounting for potentially omitted variables. That is why this article has looked not just at one measure, such as shareholder value, but at a range of measures: shareholder value (especially over the long term), operating results, CEO turnover, changes to corporate pay practices, and variations in the companies targeted. It is also why this article has looked at the three principal vectors of shareholder activism, rather than concentrating on just one. While reasonable people might disagree on whether staggered boards produce a benefit or not (it is clear, however, that they do not diminish corporate value), it is more difficult to take issue with the entire uncorrelated corpus of research on shareholder proposals, activism, and takeovers.

Taken as a whole, the empirical work performed over the past several decades suggests the good shareholder story has limited explanatory power. In general, shareholder interventions do not appear to arise from agency failures and they are not characterised by remedial actions linked to reigning in executives. In contrast, the bad shareholder story is supported again and again in the literature. Shareholder power is exercised in favour of strategies that show little engagement with the actual business realities experienced by their targets and, in the wake of their interventions, companies tend to underperform, especially over the long-term.

The biggest gains from shareholder interventions appear to derive from a limited repertoire of financial engineering moves designed to take money from retained earnings, increase debt, or sell assets. The money thus liberated is transferred to the shareholders via share buybacks, takeover premia, or dividends. There is nothing inherently bad about this, and it would take a very different article to evaluate whether, on balance, this process—the decline of equity as a source of long-term capital—is good or bad for companies and the economy as a whole.²⁶⁹

All that we are concerned about at present is whether the empirical evidence supports the good shareholder story: It does not. Regulators and market participants should therefore be cautious about automatically associating measures that increase shareholder power with improvements in the market. An example of the way this caution might play out is provided by the recent Ontario Capital Markets Modernization Taskforce’s (“Taskforce”) consultation report.²⁷⁰ The report provides multiple examples of the usefulness of understanding the superiority of the bad shareholder story over the alternative.

In relation to shareholder proposals, for example, the Taskforce recommends a streamlined process for dealing with the inclusion of proposals in issuers’ proxy materials.²⁷¹ Given the evidence suggesting shareholder proposals are generally value-impairing, it makes sense to improve the efficiency of the process by which corporations can receive approval to exclude them from their meetings.

In connection with activist shareholder campaigns, the Taskforce suggests that the early warning threshold in Canada be reduced from 10 per cent to 5 per cent, to bring the country into conformity with most other jurisdictions in the world.²⁷² Whatever the merits of making this change, a side-effect of adopting the recommendation will be to reduce the returns to shareholder activism on the margins and thus reduce the number of activist campaigns. This seems less problematic if the bad shareholder story is generally correct.

Finally, the Taskforce recommends greater powers be given to regulators to overturn management tactics designed to influence the outcome of takeovers.²⁷³ Given what we know about the market for corporate control, this recommendation, reflecting the traditional Canadian assumption of the good shareholder story,

269. Fox & Lorsch, *supra* note 37.

270. Government of Ontario, “Capital Markets Modernization Taskforce: Consultation Report” (July 2020), online (pdf): <files.ontario.ca/books/mof-capital-markets-modernization-taskforce-report-en-2020-07-09.pdf>.

271. *Ibid* at 27.

272. *Ibid* at 25. See also Cheffins, “Hedge Fund Activism”, *supra* note 103 at 19 (discussing global norms in this area).

273. Government of Ontario, *supra* note 270 at 29.

seems at least problematic.²⁷⁴ What is it about the impugned managerial actions that render them offensive? It can no longer be merely that they interfere with shareholder authority or are *prima facie* instances of self-dealing by managers. What is it about the actions in question that impair long term business outcomes? The stories, themselves, should not dictate policy conclusions; but starting with the right story does get us to ask better quality questions.

The story that we accept about shareholders shifts the burden of proof that must be met by proposals for reform. If the bad shareholder story is true, for example, then policy changes to increase shareholder power must be supported by conclusive evidence in their favour, rather than benefitting from the assumption that increasing shareholder influence is usually beneficial. As one group of legal academics note in commenting on a proposal by Lucian Bebchuk to further expand shareholder power, the old director-centric governance model was not obviously flawed. Its performance throughout the twentieth century can only be described as a great success.

The adage “if it ain’t broke don’t fix it” does not begin to capture the risk of Bebchuk’s agenda. One would rather have to say something like “if it has performed superlatively over the course of generations, and the visible preferences of the market confirm its wisdom, and its continued proper functioning is central to the nation’s economy, don’t gratuitously disassemble it.”²⁷⁵

This is a view reflected in surveys of corporate lawyers and directors, who express reservations about the trend to ever greater shareholder influence.²⁷⁶ It is even visible in the behaviour of shareholders themselves, who shy away from things like mandatory bylaw proposals that would bring them additional power, and instead focus mainly on optics.²⁷⁷ It is time to seriously reconsider the story that we have been using.

274. This assumption is reflected, for example, in Canadian regulators’ refusal to permit poison pills to serve as an effective takeover defense for more than a sharply limited period of time.

275. Theodore N Mirvis, Paul K Rowe & William Savitt, “Bebchuk’s ‘Case for Increasing Shareholder Power’: An Opposition” (2007) Harvard Law School Discussion Paper No 586 at 1, online: <www.ssrn.com/abstract=990057>.

276. See Carol Liao, “A Canadian Model of Corporate Governance” (2014) 37 Dal LJ 559 at 596-98 (noting “[a]n overwhelming majority of the practitioners did not support the trend of greater shareholder control” (*ibid* at 568)).

277. See Kahan & Rock, “Symbolic Governance”, *supra* note 145 at 1997-2043. See also Tingle, “Expressive Voting”, *supra* note 3.